Consolidation and the Variable Interest Model

Determination of a controlling financial interest (following the adoption of ASU 2015-02, Amendments to the Consolidation Analysis)

February 2016
To our clients and other friends

This Financial reporting developments publication is designed to help you navigate through the Variable Interest Model. The Variable Interest Model is complex, and knowing when and how to apply it can be challenging. Consolidation evaluations always begin with the Variable Interest Model, which applies to all legal entities, with certain limited exceptions. This publication also includes an appendix on applying the Voting Model.

The Variable Interest Model has evolved over the years in response to the needs of users of financial statements. The existing model, established in 2009 in FAS 167, focuses on identifying the reporting entity with power to make the decisions that most significantly impact an entity's economic performance. That power may be exercisable through equity interests or other means. It also requires determining whether the reporting entity with power has benefits, that is, the obligation to absorb losses or the right to receive benefits from the entity that potentially could be significant to the entity.

In February 2015, the FASB issued Accounting Standard Update (ASU) 2015-02, Amendments to the Consolidation Analysis, which makes changes to both the Variable Interest Model and the Voting Model including the following:

- The elimination of the deferral of FAS 167, which allowed reporting entities with interests in certain investment funds to follow the consolidation guidance in FIN 46(R)
- The removal of certain criteria used in the determination of whether fees paid to a decision maker or service provider are a variable interest
- In the determination of whether an entity is a VIE, the evaluation of power changed when determining whether, as a group, the holders of the equity investment at risk lack the characteristics of a controlling financial interest
- In the identification of the primary beneficiary, a reporting entity that is determining whether it satisfies the benefits criterion will now exclude most fees that are both customary and commensurate
- The “related party tie-breaker” test will be used in fewer circumstances
- The elimination of the presumption in today’s Voting Model that a general partner controls a limited partnership (although a general partner may consolidate a limited partnership under the Variable Interest Model).

We have updated this edition for ASU 2015-02 and for the 2015 AICPA National Conference on Current SEC and PCAOB Developments. We also provided further clarifications and enhancements to our interpretative guidance. These changes are summarized in Appendix J. We hope this publication will help you understand and apply the consolidation models in ASC 810, as amended by ASU 2015-02. We are also available to discuss any particular questions that you may have.

Ernst & Young LLP

February 2016
# Contents

## 1 Overview

1.1 The models .................................................................................................................. 1

1.1.1 Variable Interest Model .............................................................................................. 1

1.1.2 Voting Model ............................................................................................................... 2

1.2 Navigating the Variable Interest Model ..................................................................... 4

1.2.1 Step 1. Does a scope exception to consolidation guidance (ASC 810) apply? .......... 4

1.2.2 Step 2. Does a scope exception to the Variable Interest Model apply? .................. 4

1.2.3 Step 3. Does the reporting entity have a variable interest in an entity? ................. 6

1.2.4 Step 4. Is the entity a VIE? ....................................................................................... 8

1.2.5 Step 5. If the entity is a VIE, is the reporting entity the primary beneficiary? .......... 13

1.3 Summary .................................................................................................................... 17

## 2 Definitions of terms

2.1 Legal entity .................................................................................................................. 18

2.2 Controlling financial interest ..................................................................................... 18

2.3 Common control ......................................................................................................... 19

2.4 Decision maker and decision-making authority ......................................................... 21

2.5 Power .......................................................................................................................... 21

2.6 Expected losses, expected residual returns and expected variability ....................... 21

2.7 Indirect interest (Updated February 2016) .................................................................. 22

2.8 Kick-out rights and liquidation rights ......................................................................... 23

2.9 Participating rights ..................................................................................................... 24

2.10 Protective rights ....................................................................................................... 24

2.11 Primary beneficiary ................................................................................................... 25

2.12 Related parties and de facto agents ............................................................................ 25

2.13 Subordinated financial support .................................................................................. 26

2.14 Variable interest entity .............................................................................................. 27

2.15 Variable interests ...................................................................................................... 27

2.16 Collateralized financing entity ................................................................................... 28

2.17 Voting interest entity ................................................................................................. 28

2.18 Private company ......................................................................................................... 28

2.19 Public business entity ............................................................................................... 29

2.20 Reporting entity and entity ...................................................................................... 29

## 3 Consideration of substantive terms, transactions and arrangements

## 4 Scope

4.1 Introduction .................................................................................................................. 32

4.2 Legal entities ................................................................................................................. 32

4.2.1 Common arrangements/entities subject to the Variable Interest Model ................. 33

4.2.2 Portions of entities .................................................................................................... 35

4.2.3 Collaborative arrangements not conducted through a separate entity .................... 36

4.2.4 Majority-owned entities ............................................................................................ 36
4.2.5 Application of Variable Interest Model to tiered structures ............................................. 37
4.2.6 Fiduciary accounts, assets held in trust ........................................................................ 38
4.2.7 Series funds (Updated February 2016) ........................................................................ 38
4.3 Scope exceptions to consolidation guidance ........................................................................ 40
  4.3.1 Employee benefit plans .................................................................................................. 41
    4.3.1.1 Employee benefit plans not subject to ASC 712 or 715 ....................................... 41
    4.3.1.2 Employee stock ownership plans ........................................................................ 42
    4.3.1.3 Deferred compensation trusts (e.g., a rabbi trust) .............................................. 42
    4.3.1.4 Applicability of the Variable Interest Model to the financial statements of employee benefit plans .............................................................. 43
    4.3.1.5 Service providers to employee benefit plans ...................................................... 43
  4.3.2 Investment companies ................................................................................................ 43
  4.3.3 Governmental entities ................................................................................................ 44
    4.3.3.1 Governmental financing entities ......................................................................... 44
  4.3.4 Money market funds ................................................................................................... 45
4.4 Scope exceptions to the Variable Interest Model .................................................................... 46
  4.4.1 Not-for-profit organizations ......................................................................................... 48
    4.4.1.1 Not-for-profit organizations used to circumvent consolidation ......................... 49
    4.4.1.2 Not-for-profit organizations as related parties .................................................... 50
  4.4.2 Separate accounts of life insurance reporting entities ................................................... 50
  4.4.3 Information availability ............................................................................................... 50
  4.4.4 Business scope exception ......................................................................................... 52
    4.4.4.1 Definition of a business (Updated February 2016) .............................................. 52
    4.4.4.2 Significant participation in the design or redesign of an entity ............................. 53
      4.4.4.2.1 Determining whether an entity is a joint venture ..................................... 53
      4.4.4.2.2 Determining whether an entity is a franchisee .......................................... 55
    4.4.4.3 Substantially all of the activities of an entity either involve or are conducted on behalf of a reporting entity .................................................. 56
    4.4.4.4 A reporting entity and its related parties have provided more than half of an entity's subordinated financial support .............................................. 56
  4.4.5 Private company accounting alternative ....................................................................... 57
5 Evaluation of variability and identifying variable interests .................................................... 59
  5.1 Introduction .................................................................................................................... 59
  5.2 Step-by-step approach to identifying variable interests .................................................... 60
    5.2.1 Step 1: Determine the variability an entity was designed to create and distribute ........ 61
      5.2.1.1 Consideration 1: What is the purpose for which the entity was created? .......... 62
      5.2.1.2 Consideration 2: What is the nature of the risks in the entity? ......................... 62
        5.2.1.2.1 Certain interest rate risk ....................................................................... 63
        5.2.1.2.2 Terms of interests issued ....................................................................... 65
        5.2.1.2.3 Subordination ..................................................................................... 65
    5.2.2 Step 2: Identify variable interests ............................................................................. 66
      5.2.2.1 Consideration 1: Which variable interests absorb the variability designated in Step 1? ................................................................. 67
      5.2.2.2 Consideration 2: Is the variable interest in a specified asset of a VIE, a silo or a VIE as a whole? .............................................................. 69
  5.3 Quantitative approach to identifying variable interests ..................................................... 69
5.4 Illustrative examples of variable interests ................................................................. 70
  5.4.1 Equity investments............................................................................................... 70
    5.4.1.1 Interests held by employees ...................................................................... 70
  5.4.2 Beneficial interests and debt instruments ......................................................... 71
  5.4.3 Trust preferred securities .................................................................................. 71
  5.4.4 Derivative instruments ....................................................................................... 75
    5.4.4.1 Common derivative contracts ................................................................. 77
    5.4.4.2 Forward contracts .................................................................................... 79
    5.4.4.3 Total return swaps .................................................................................... 79
    5.4.4.4 Embedded derivatives .............................................................................. 81
  5.4.5 Financial guarantees, written puts and similar obligations .............................. 84
  5.4.6 Purchase and supply contracts ......................................................................... 85
  5.4.7 Operating leases ............................................................................................... 86
    5.4.7.1 Private company accounting alternative .................................................. 86
  5.4.8 Lease prepayments ......................................................................................... 86
  5.4.9 Local marketing agreements and joint service agreements in the broadcasting industry ................................................................. 87
    5.4.9.1 Local marketing agreements .................................................................. 87
    5.4.9.2 Joint service agreements ....................................................................... 88
  5.4.10 Purchase and sale contracts for real estate ..................................................... 88
  5.4.11 Netting or offsetting contracts ....................................................................... 89
  5.4.12 Implicit variable interests ................................................................................ 91
  5.4.13 Fees paid to decision makers or service providers ........................................ 94
    5.4.13.1 Conditions (a) and (d): Fees are commensurate with the level of effort required and include only customary terms and conditions (Updated February 2016) ................................................................. 97
    5.4.13.2 Condition (c): Other interests held by a decision maker or service provider ................................................................. 99
      5.4.13.2.1 Interests held by related parties when evaluating fees paid to a decision maker or service provider (Updated February 2016) .............. 101
      5.4.13.2.2 Interests held by employees when evaluating fees paid to a decision maker or service provider ................................................................. 104
    5.4.13.3 Fees that expose a reporting entity to risk of loss .................................. 105
    5.4.13.4 Reconsideration of a decision maker’s or service provider’s fees as variable interests ................................................................. 105
  5.5 Variable interests in specified assets .................................................................... 107
6 Silos ...................................................................................................................... 110
  6.1 Introduction ........................................................................................................... 110
  6.2 Determining whether the host entity is a VIE when silos exist (Updated February 2016) .... 113
  6.3 Effect of silos on determining variable interests in specified assets .................. 116
    6.3.1 Relationship between specified assets and silos ........................................ 118
7 Determining whether an entity is a VIE ................................................................. 119
  7.1 Introduction ........................................................................................................... 119
  7.2 The entity does not have enough equity to finance its activities without additional subordinated financial support ................................................................. 119
    7.2.1 Forms of investments that qualify as equity investments .......................... 121
7.2.2 Determining whether an equity investment is at risk ...................................................... 123
  7.2.2.1 Equity investment participates significantly in both profits and losses ........ 123
  7.2.2.2 Equity interests that were issued by the entity in exchange for
          subordinated interests in other VIEs ......................................................... 125
  7.2.2.3 Amounts provided to the equity investor directly or indirectly by
          the entity or by other parties involved with the entity ............................ 125
  7.2.2.4 Amounts financed for the equity holder directly by the entity or
          by other parties involved with the entity ................................................... 129
  7.2.2.5 Other examples of determining equity investments at risk .................... 131

7.2.3 Methods for determining whether an equity investment at risk is sufficient ................ 133
  7.2.3.1 10% test – a misnomer ............................................................................ 134
  7.2.3.2 The entity can finance its activities without additional
          subordinated financial support ................................................................ 135
  7.2.3.3 The entity has at least as much equity invested as other entities
          that hold only similar assets of similar quality in similar amounts
          and operate with no additional subordinated financial support .............. 135
  7.2.3.4 The amount of equity invested in the entity exceeds the estimate of the
          entity's expected losses based on reasonable quantitative evidence .......... 137
  7.2.3.5 Illustrative examples ............................................................................... 138

7.2.4 Development stage entities ....................................................................................... 140

7.3 The equity holders, as a group, lack the characteristics of a controlling
financial interest ............................................................................................................ 140
  7.3.1 The power, through voting rights or similar rights, to direct the activities of an
          entity that most significantly impact the entity's economic performance .... 141
    7.3.1.1 Step 1: Consider purpose and design ................................................. 143
    7.3.1.2 Step 2: Identify the activities that most significantly impact the
          entity's economic performance ................................................................. 143
    7.3.1.3 Step 3: Identify how decisions about significant activities are
          made and the party or parties that make them ...................................... 143
      7.3.1.3.1 Corporations and similar entities ............................................. 144
      7.3.1.3.2 Limited partnerships and similar entities .............................. 147
      7.3.1.3.3 Kick-out rights ........................................................................ 148
      7.3.1.3.4 Participating rights ................................................................. 150
      7.3.1.3.5 Protective rights .................................................................. 151
    7.3.1.4 Effect of decision makers or service providers when evaluating
          ASC 810-10-15-14(b)(1) ......................................................................... 153
    7.3.1.5 Franchise arrangements when evaluating ASC 810-10-15-14(b)(1) .... 154
    7.3.1.6 Limited liability companies ............................................................... 156

7.3.2 Obligation to absorb an entity's expected losses ......................................................... 157
  7.3.2.1 Common arrangements that may protect equity investments at risk
          from absorbing losses ............................................................................. 160
  7.3.2.2 Disproportionate sharing of losses ..................................................... 162
  7.3.2.3 Variable interests in specified assets or silos ..................................... 162
  7.3.2.4 Illustrative examples .......................................................................... 163

7.3.3 Right to receive an entity’s expected residual returns .............................................. 164
  7.3.3.1 Disproportionate sharing of profits .................................................... 167
  7.3.3.2 Variable interests in specified assets or silos ..................................... 167
  7.3.3.3 Illustrative examples .......................................................................... 168
7.4 Entity established with non-substantive voting rights ....................................................... 169
  7.4.1 Condition 1: Disproportionate votes to economics ....................................................... 170
  7.4.2 Condition 2: Substantially all of an entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights ....................................................... 172
  7.4.3 Related party and de facto agent considerations ....................................................... 174
  7.4.4 Illustrative examples ................................................................................................. 176
7.5 Initial determination of VIE status ....................................................................................... 177

8 Primary beneficiary determination ............................................................................................. 179
  8.1 Introduction ...................................................................................................................... 179
  8.2 Power ............................................................................................................................... 180
    8.2.1 Step 1: Consider purpose and design .......................................................................... 181
      8.2.1.1 Involvement with the design of the VIE ................................................................. 181
    8.2.2 Step 2: Identify the activities that most significantly impact the VIE's economic performance .............................................................................................. 181
    8.2.3 Steps 3 and 4: Identify how decisions about significant activities are made and the party or parties that make them............... 183
      8.2.3.1 Related party considerations .............................................................................. 185
      8.2.3.2 Situations in which no party has the power over a VIE ........................................ 185
      8.2.3.3 Shared power ................................................................................................. 186
      8.2.3.4 Power conveyed through a board of directors and no one party controls the board ................................................................. 187
      8.2.3.5 Multiple unrelated parties direct the same activities that most significantly impact the VIE's economic performance ....................................................... 188
      8.2.3.6 Multiple unrelated parties direct different activities that most significantly impact the VIE's economic performance ....................................................... 188
        8.2.3.6.1 Different parties with power over the entity's life cycle ........................................ 189
        8.2.3.6.2 Evaluating rights held by the board of directors and an operations manager in an operating entity ................................................................. 190
    8.2.4 Kick-out rights, participating rights and protective rights ............................................. 192
      8.2.4.1 Kick-out rights ..................................................................................................... 192
      8.2.4.2 Participating rights .............................................................................................. 193
      8.2.4.3 Protective rights ................................................................................................. 194
      8.2.4.4 Potential voting rights (e.g., call options, convertible instruments) ...................... 195
  8.3 Benefits ............................................................................................................................. 195
    8.3.1 Fees paid to decision makers or service providers ....................................................... 196
    8.3.2 Evaluating disproportionate power and benefits ....................................................... 198
  8.4 Other frequently asked questions ....................................................................................... 200

9 Determining the primary beneficiary in a related party group ............................................. 202
  9.1 Introduction ...................................................................................................................... 202
  9.2 Single decision maker (Updated February 2016) ................................................................ 203
  9.3 Shared power among multiple related parties .................................................................... 207
  9.4 Multiple decision makers within the related party group ....................................................... 208
  9.5 Determining which party is most closely associated with a VIE ........................................... 209
    9.5.1 Principal-agency relationship ..................................................................................... 209
    9.5.2 Relationship and significance of a VIE's activities to members of a related party group ................................................................. 210
9.5.3 Exposure to variability associated with the anticipated economic performance of the VIE ................................................................. 211
9.5.4 Purpose and design .................................................................................................................................................................... 211
9.6 One member of a related party group not clearly identified ........................................................................................................... 211

10 Related parties and de facto agents ............................................................................................................................ 213
10.1 Related parties ........................................................................................................................................................................... 213
10.2 De facto agents ............................................................................................................................................................................ 213
  10.2.1 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 ........................................................................ 214
    10.2.1.1 One-sided versus two-sided restrictions .............................................................................................................................. 215
    10.2.1.2 Common contractual terms ........................................................................................................................................................ 215
      10.2.1.2.1 Right of first refusal ............................................................................................................................................................. 215
      10.2.1.2.2 Right of first offer ............................................................................................................................................................... 216
      10.2.1.2.3 Approval cannot be unreasonably withheld ....................................................................................................................... 216
  10.2.2 A party that has a close business relationship ..................................................................................................................... 216
  10.2.3 Separate accounts of insurance enterprises as potential related parties ........................................................................... 216

11 Reconsideration events ............................................................................................................................................................. 217
11.1 Reconsideration of whether an entity is a VIE .................................................................................................................................. 217
  11.1.1 Common VIE reconsideration events .................................................................................................................................. 218
    11.1.1.1 Conversions of accounts receivables into notes ..................................................................................................................... 220
    11.1.1.2 Transfer of an entity’s debt between lenders ........................................................................................................................ 220
    11.1.1.3 Asset acquisitions and dispositions ........................................................................................................................................ 220
    11.1.1.4 Distributions to equity holders ............................................................................................................................................... 221
    11.1.1.5 Replacement of temporary financing with permanent financing ............................................................................................ 222
    11.1.1.6 Adoption of accounting standards ........................................................................................................................................ 222
    11.1.1.7 Incurrence of losses that reduce the equity investment at risk ............................................................................................... 222
    11.1.1.8 Acquisition of a business that has a variable interest in an entity .......................................................................................... 222
    11.1.1.9 Bankruptcy .................................................................................................................................................................................. 223
    11.1.1.10 Loss of power or similar rights .............................................................................................................................................. 223
  11.2 Reconsideration of whether a reporting entity is the primary beneficiary ................................................................................ 224

12 Initial measurement and consolidation .......................................................................................................................... 225
12.1 Introduction .................................................................................................................................................................................. 225
12.2 Primary beneficiary and VIE are under common control ........................................................................................................... 225
12.3 Primary beneficiary of a VIE that is a business ........................................................................................................................ 225
12.4 Primary beneficiary of a VIE that is not a business .................................................................................................................... 226
  12.4.1 Contingent consideration in an asset acquisition when the entity is a VIE that does not constitute a business .......................................................... 227
12.5 Primary beneficiary of a VIE that is a collateralized financing entity ........................................................................................... 227
12.6 Other considerations ...................................................................................................................................................................... 228
  12.6.1 Pro forma and Form 8-K reporting requirements .................................................................................................................... 228
  12.6.2 SEC Regulation S-X Rules 3-05 and 3-14 and Form 8-K reporting requirements ........................................................................ 228
12.7 Pre-existing hedge relationships under ASC 815 ........................................................................................................................ 229
12.8 Continuation of leveraged lease accounting by an equity investor in a deconsolidated lessor trust .......................................................................................................................... 229
Contents

13 Presentation and disclosures ................................................................. 230
  13.1 Presentation .................................................................................. 230
  13.2 Disclosures .................................................................................. 232
  13.2.1 Disclosure objectives ................................................................. 232
  13.2.2 Primary beneficiaries of VIEs ...................................................... 233
  13.2.3 Holders of variable interests in VIEs that are not primary beneficiaries .......... 234
  13.2.4 All holders of variable interests in VIEs ......................................... 235
  13.2.5 Scope-related disclosures ............................................................ 236
  13.2.6 Aggregation of certain disclosures .............................................. 236
  13.2.7 Public company MD&A disclosure requirements......................... 238
  13.2.8 Private company accounting alternative ...................................... 238

14 Effective date and transition ................................................................. 239
  14.1 Effective date ................................................................................ 239
  14.2 Transition .................................................................................... 239
  14.2.1 Recognition ................................................................................ 241
  14.2.2 Initial measurement when a reporting entity consolidates an entity ......... 242
    14.2.2.1 Reconsideration events ......................................................... 243
    14.2.2.2 Fair value option .................................................................... 244
    14.2.2.3 Practicability exceptions ....................................................... 245
  14.2.3 Initial measurement when a reporting entity deconsolidates an entity .... 247
  14.2.4 Retrospective application ............................................................ 249
    14.2.4.1 SEC reporting implications of adopting ASU 2015-02 ............ 250

A Expected losses and expected residual returns ...................................... A-1
  A.1 Introduction .................................................................................. A-1
  A.2 Expected losses, expected residual returns and expected variability .......... A-1
  A.3 Calculating expected losses and expected residual returns .................... A-2
    A.3.1 Effect of variable interests in specified assets or silos .................... A-5
  A.4 Allocation of expected losses and expected residual returns ................ A-5
  A.5 Reasonableness checks .................................................................. A-10
  A.6 Approaches to calculate expected losses and expected returns ............... A-11
    A.6.1 Fair value, cash flow and cash flow prime methods ....................... A-12
      A.6.1.1 Fair value method ............................................................... A-12
      A.6.1.2 Cash flow method ............................................................... A-13
      A.6.1.3 Cash flow prime method .................................................... A-13
  A.7 Inability to obtain the information .................................................... A-17
  A.8 Example analysis of sufficiency of equity ......................................... A-17

B Affordable housing projects ................................................................. B-1
  B.1 Summary of the tax credit .............................................................. B-1
  B.2 Summary of the investment ............................................................. B-1
  B.3 Primary beneficiary considerations ............................................... B-3

C Voting Model and consolidation of entities controlled by contract ............ C-1
  C.1 Introduction .................................................................................. C-1
    C.1.1 SEC regulations on consolidation .............................................. C-2
    C.1.2 Scope of the voting interest entity model .................................... C-2
  C.2 Voting Model: Controlling financial interests .................................... C-3
C.2.1 Voting Model: Consolidation of corporations ............................................................. C-3
  C2.1.1 Consolidation of a not-for-profit organization other than a partnership .......... C-4
C.2.2 Voting Model: Control of limited partnerships and similar entities ..................... C-4
C.2.3 Circumstances when more than a simple majority is required for control .............. C-6
C.2.4 Evaluating indirect control .................................................................................... C-7
C.2.5 Evaluating call options, convertible instruments and other potential voting rights .............................................................................................................. C-9
C.2.6 Control when owning less than a majority of voting rights .................................... C-9
  C.2.6.1 Evaluating size of minority investment relative to other minority investors .............................................................................................................. C-9
C.3 Exceptions to consolidation by a reporting entity holding a majority of voting stock or limited partnership interests ................................................................. C-10
  C.3.1 Foreign currency exchange restrictions (Updated February 2016) ....................... C-11
C.3.2 Evaluating the effect of noncontrolling rights ......................................................... C-12
  C.3.2.1 Participating rights ....................................................................................... C-13
  C.3.2.1.1 Evaluating the substance of noncontrolling rights .................................... C-16
  C.3.2.2 Protective rights ....................................................................................... C-20
  C.3.2.3 Assessment of noncontrolling rights ......................................................... C-21
C.4 Control by contract .................................................................................................... C-21
D Private Company Council alternative for lessors in common control leasing arrangements ............................................................................................................. D-1
  D.1 Overview and scope ............................................................................................. D-1
    D.1.1 Definition of a private company and public business entity ......................... D-3
  D.2 Evaluating common control ................................................................................ D-4
  D.3 Identifying a leasing arrangement ......................................................................... D-4
  D.4 Evaluating whether activities relate to the leasing activities ................................ D-4
  D.5 Evaluating a guarantee or collateralization of a leasing entity's obligations ......... D-5
  D.6 Illustrations ......................................................................................................... D-5
  D.7 Disclosure ........................................................................................................... D-7
  D.8 Elimination of implicit variable interest guidance applicable to all entities .......... D-8
  D.9 Effective date and transition ............................................................................. D-8
E Measurement alternative for consolidated collateralized financing entities .......... E-1
  E.1 Overview ............................................................................................................. E-1
  E.2 Scope .................................................................................................................. E-1
  E.3 Initial measurement ............................................................................................ E-2
  E.4 Subsequent measurement ................................................................................... E-4
  E.5 Disclosure ........................................................................................................... E-5
  E.6 Effective date and transition ............................................................................. E-5
F Investment companies .............................................................................................. F-1
  F.1 Overview ............................................................................................................. F-1
  F.1.1 Attributes of an investment company ................................................................ F-1
  F.2 Consolidation by an investment company ............................................................. F-2
    F.2.1 Master/feeder and fund of funds structures .................................................... F-5
    F.2.1.1 SEC staff views on consolidation in master/feeder and fund of funds structures .............................................................................................................. F-6
  F.3 Consolidation of investment companies ............................................................... F-7
Lot option contracts (Updated February 2016) ................................................................. G-1
  G.1 Introduction ................................................................................................................. G-1
  G.2 Background ............................................................................................................... G-1
  G.3 Determining whether a homebuilder has a variable interest in the entity .............. G-2
    G.3.1 Variable interests in specified assets ................................................................. G-2
    G.3.2 Other considerations ......................................................................................... G-2
  G.4 Determining whether the entity is a VIE ................................................................. G-3
    G.4.1 The entity does not have sufficient equity to finance its activities without additional subordinated financial support ................................................................. G-3
    G.4.2 The equity holders, as a group, lack the characteristics of a controlling financial interest .................................................................................................................. G-3
      G.4.2.1 The power through voting rights or other rights to direct the activities on an entity that most significantly impact the entity’s economic performance ......................................................... G-3
      G.4.2.2 Obligation to absorb the entity’s expected losses ........................................ G-4
      G.4.2.3 Right to receive the entity’s expected residual returns ................................ G-4
    G.4.3 Entity established with non-substantive voting rights ..................................... G-4
  G.5 Determining whether the homebuilder is the primary beneficiary ....................... G-5
    G.5.1 Power .................................................................................................................... G-5
    G.5.2 Benefits ............................................................................................................... G-5
  G.6 Reconsideration events ............................................................................................. G-6
  G.7 Recognition and measurement .................................................................................. G-6
  G.8 Disclosures ................................................................................................................. G-6

Abbreviations used in this publication ........................................................................ H-1

Index of ASC references in this publication ................................................................ I-1

Summary of important changes ..................................................................................... J-1
Notice to readers:

This publication includes excerpts from and references to the FASB Accounting Standards Codification (the Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication, references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification or to distinguish the Variable Interest Model under ASU 2015-02 and FAS 167 from FIN 46(R).

This publication has been carefully prepared, but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.
1 Overview

Under the traditional Voting Model, ownership of a majority voting interest is the determining factor for a controlling financial interest. However, the Voting Model is not effective in identifying controlling financial interests in entities that are controlled through other means. Under the Variable Interest Model, reporting entities may be required to consolidate entities in which the power to make decisions comes from a variety of equity, contractual or other interests, collectively known as “variable interests.”

By describing the model and highlighting some common misconceptions in this overview, we hope to help you navigate through the complexity of the Variable Interest Model. Throughout this publication, we refer to the entity evaluating another entity for consolidation as the “reporting entity” and the entity subject to consolidation as the “entity.” Comprehensive guidance on applying the model is included in the chapters that follow.

1.1 The models

There are two primary consolidation models under US GAAP: (1) the Variable Interest Model and (2) the Voting Model.

The Variable Interest Model applies to an entity in which the equity does not have characteristics of a controlling financial interest. An entity that is not a variable interest entity (VIE) is often referred to as a voting interest entity.

1.1.1 Variable Interest Model

Consolidation evaluations always begin with the Variable Interest Model, which was designed to enable a reporting entity to determine whether an entity should be evaluated for consolidation based on variable interests or voting interests. Regardless of what type of entity a reporting entity is evaluating for consolidation, it should first consider the provisions of the Variable Interest Model. The Variable Interest Model applies to all legal entities, including corporations, partnerships, limited liability companies and trusts. Even a majority-owned entity may be a VIE that is subject to consolidation in accordance with the Variable Interest Model.

<table>
<thead>
<tr>
<th>Misconception: Operating entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Variable Interest Model does not apply to the entity I am evaluating because the entity is an operating entity.</td>
</tr>
<tr>
<td>A common misconception is that the Variable Interest Model does not apply because the entity being evaluated for consolidation is a traditional operating entity (e.g., a business). Many tend to associate the evaluation of an operating entity with the Voting Model. The Variable Interest Model, however, applies to all legal entities. The Codification defines a legal entity as “any legal structure used to conduct activities or to hold assets” and is intentionally broad. Therefore, a traditional operating entity must first be evaluated using the Variable Interest Model and may be a VIE.</td>
</tr>
</tbody>
</table>

1 There are five scope exceptions specific to the Variable Interest Model: (1) not-for-profit organizations, (2) separate accounts of life insurance companies, (3) lack of information, (4) certain legal entities deemed to be businesses and (5) a private company accounting alternative. See Section 4.4 for further details.
Entities subject to the Variable Interest Model include the following:

- Corporations
- Partnerships
- Limited liability companies
- Other unincorporated entities
- Majority-owned subsidiaries
- Grantor trusts

Arrangements that, while established by contract, are not conducted through a separate entity are not subject to the Variable Interest Model.

### Illustration 1-1: No legal entity

Assume two companies enter into a joint marketing arrangement. They agree to collaboratively produce marketing materials and to use their existing sales channels to market each other’s products and services. Each company contractually agrees to share a specified percentage of the revenues received from the sale of products and services made under the joint marketing arrangement to customers of the other company. However, no separate entity is established to conduct the joint marketing activities, and each company retains its own assets and continues to conduct its activities separate from the other.

**Analysis**

Although the companies have contractually agreed to the joint arrangement, the provisions of the Variable Interest Model do not apply to the arrangement because no separate entity has been established to conduct the joint marketing activities.

### 1.1.2 Voting Model

The Voting Model generally can be subdivided into two categories: (1) consolidation of corporations and (2) consolidation of limited partnerships and similar entities. Consolidation of corporations is based upon whether a reporting entity owns more than 50% of the outstanding voting shares of an entity. This, of course, is a general rule.

There are exceptions, such as when the entity is in bankruptcy or when minority shareholders have certain approval or veto rights. Consolidation based on a majority voting interest may apply to entities other than corporations. However, we use the term “corporation” to distinguish from the approach applied to limited partnerships and similar entities.

For limited partnerships and similar entities (e.g., limited liability companies) that are not VIEs, generally, only a single limited partner that is able to exercise substantive kick-out rights will consolidate the entity. A general partner will not consolidate a limited partnership.

In addition to the Variable Interest and Voting Models, ASC 810-10 also includes a subsection, *Consolidation of Entities Controlled by Contract*. This subsection provides guidance on the consolidation of entities controlled by contract that are determined not to be VIEs. However, we believe application of this guidance is limited because entities controlled by contract generally are VIEs. See Appendix C for further guidance on the Voting Model and entities controlled by contract.
The following chart illustrates how to generally apply consolidation accounting guidance.¹

1. **Start**
   - Is the entity being evaluated for consolidation a legal entity?
     - Yes
     - No
       - Apply other US GAAP²

2. **Does a scope exception to the Variable Interest Model apply?**
   - Does the reporting entity have a variable interest in a legal entity?
     - No
     - Yes
       - Apply other US GAAP²

3. **Variable Interest Model**
   - Is the reporting entity the primary beneficiary (i.e., does the reporting entity individually have both power and benefits)?
     - No
     - Yes
       - Consolidate entity

4. **Voting Model**
   - Does the reporting entity, directly or indirectly, have greater than 50% of the outstanding voting shares (consider other contractual rights)?
     - No
     - Yes
       - Do not consolidate³

5. **Consider whether fees paid to a decision maker or service provider represent a variable interest?**
   - No
     - Yes
       - Do not consolidate. Apply other US GAAP²

6. **Consider whether silos exist or whether the interests or other contractual arrangements of the entity (excluding interests in silos) qualify as variable interests in the entity as a whole?⁴**
   - No
     - Yes
       - Apply other US GAAP²

7. **Variable Interest Model**
   - Is the reporting entity the primary beneficiary (i.e., does the reporting entity individually have both power and benefits)?
     - No
     - Yes
       - Consolidate entity

8. **Does the decision maker's related party group collectively have the characteristics of a primary beneficiary?**
   - No
     - Yes
       - Apply the "most closely associated" test

9. **Does decision maker have benefits (considering both direct and indirect interests)?**
   - No
     - Yes
       - Apply "most closely associated" test

10. **Does the decision maker's related party group collectively have the characteristics of the primary beneficiary?**
    - No
      - Yes
        - Are the decision maker and its related party or parties under common control?
          - No
            - No
              - Are "substantially all" of the VIE's activities conducted on behalf of a single variable interest holder that is related party of the decision maker?²
                - No
                  - No
                    - Do not consolidate
                - Yes
                  - Yes
                    - Single VI holder (not the decision maker) consolidates
              - Yes
                - Yes
                  - Yes
                    - Consolidate entity
                - No
                  - Yes
                    - Do not consolidate
            - Yes
              - No
                - No
                  - Do not consolidate
                - Yes
                  - Yes
                    - Do not consolidate
          - Yes
            - No
              - No
                - No
                  - Do not consolidate
                - Yes
                  - Yes
                    - Do not consolidate
            - Yes
              - Yes
                - No
                  - No
                    - Do not consolidate
                - Yes
                  - Yes
                    - Do not consolidate

¹ This provision does not apply to certain entities that invest in qualified affordable housing projects through limited partnerships.

² See Section 2.7 for a summary on recent standard setting activity associated with potential changes to the indirect interests considerations in the VIE model.

³ Consolidation is not required; however, evaluation of other US GAAP may be relevant to determine recognition, measurement or disclosure.

⁴ The Variable Interest Model does not apply. However, the General Subsections (i.e., the Voting Model) or the Consolidation of Entities Controlled by Contract Subsections or Subtopic 810-30 on research and development arrangements may be relevant.

⁵ The ASU says a legal entity is a VIE if any of the following conditions exist:
   a. The total equity investment at risk is not sufficient to permit the legal entity to finance its activities without additional uncommitted financial support provided by any parties, including equity holders.
   b. As a group, the holders of the equity investment at risk lack any one of the following three characteristics of a controlling financial interest:
      i. The power, through voting or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance.
      ii. The obligation to absorb expected losses that are not proportionately shared among participants or are not adequately protected through claims on general partnership assets.
      iii. The right to receive expected returns that are not proportionately shared among participants and are not adequately protected through claims on general partnership assets.
   c. The equity investors' voting rights are not proportional to their economic interests.

⁶ Power refers to the power to direct the activities of a VIE that most significantly impact the VIE's economic performance (810-10-25-38A(a)), and economics refers to 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 (810-10-25-38A(b)). For purposes of determining whether it is the primary beneficiary of a VIE, a reporting entity with a variable interest shall include its direct economic interests in the entity and its indirect economic interests in the entity held through related parties (810-10-25-38D through 38E) and shall exclude fees paid to the reporting entity that satisfy both of the following conditions:
   a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
   b. The compensation arrangement includes only terms, conditions or amounts that are customary in arrangements for similar services negotiated on an arm's-length basis.

⁷ The Voting Model does not apply. However, the Consolidation of Entities Controlled by Contract Subsections or Subtopic 810-30 on research and development arrangements may be relevant.
1.2 Navigating the Variable Interest Model

As shown in the flowchart above, it helps to evaluate the Variable Interest Model in an orderly manner by asking the following questions:

1. Does a scope exception to consolidation guidance (ASC 810) apply?
2. Does a scope exception to the Variable Interest Model apply?
3. If a scope exception does not apply, does the reporting entity have a variable interest in an entity?
4. If the reporting entity has a variable interest in an entity, is the entity a VIE?
5. If the entity is a VIE, is the reporting entity the primary beneficiary of that entity?

1.2.1 Step 1. Does a scope exception to consolidation guidance (ASC 810) apply?

There are four scope exceptions to the consolidation guidance in ASC 810:

- Employee benefit plans – An employer should not consolidate its sponsored employee benefit plans that are subject to the provisions of ASC 712 or 715.

- Governmental organization – A reporting entity should not consolidate a governmental organization. A reporting entity also should not consolidate a financing entity established by a governmental organization, unless the financing entity is not a governmental organization and the reporting entity is using it in a manner similar to a VIE to circumvent the Variable Interest Model’s provisions.

- Certain investment companies – Reporting entities that are investment companies are not required to consolidate their investments under ASC 810. That is, investments made by an investment company are accounted for at fair value in accordance with the specialized accounting guidance in ASC 946 and are not subject to consolidation.

- Money market funds – Reporting entities are exempt from consolidating money market funds that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 (the 1940 Act).

It is important to note that investment companies themselves are subject to consolidation under the Variable Interest Model. In other words, reporting entities investing in or providing services to an investment company entity (e.g., an asset manager) are required to evaluate the investment company for consolidation. However, entities subject to the Securities and Exchange Commission (SEC) Regulation S-X Rule 6-03(c)(1)² are not required to consolidate an entity that is subject to that same rule.

1.2.2 Step 2. Does a scope exception to the Variable Interest Model apply?

There are five other scope exceptions specific to the Variable Interest Model:

---

² Entities subject to Regulation S-X Rule 6-03(c)(1) include, but are not limited to, Regulated Investment Companies, Unit Investment Trusts, Small Business Investment Companies and Business Development Companies. Generally, an investment company is required to register with the SEC under the 1940 Act if either (1) its outstanding shares, other than short-term paper, are beneficially owned by more than 100 persons or (2) it is offering or proposing to offer its securities to the public.
Not-for-profit (NFP) organizations — NFP organizations should not evaluate an entity for consolidation under the Variable Interest Model. Likewise, a for-profit reporting entity should not evaluate an NFP organization for consolidation under the Variable Interest Model.3

Separate accounts of life insurance reporting entities — Separate accounts of life insurance reporting entities as described in ASC 944 are not subject to the provisions of the Variable Interest Model.

Lack of information — A reporting entity is not required to apply the provisions of the Variable Interest Model to entities created before 31 December 2003 if the reporting entity is unable to obtain information necessary to (1) determine whether the entity is a VIE, (2) determine whether the reporting entity is the primary beneficiary or (3) perform the accounting required to consolidate the entity. However, to qualify for this scope exception, the reporting entity must have made and must continue to make exhaustive efforts to obtain the information.

Certain entities deemed to be a business — See the business scope exception below.

Private company accounting alternative — A private company is not required to evaluate lessors in certain common control leasing arrangements under the provisions of the Variable Interest Model if certain criteria are met. See Section 4.4.5 and Appendix D for further information.

Business scope exception

A reporting entity is not required to apply the provisions of the Variable Interest Model to an entity that is deemed to be a “business” (as defined by ASC 805) unless any of the following conditions exist:

- The reporting entity, its related parties or both, participated significantly in the design or redesign of the entity, suggesting that the reporting entity may have had the opportunity and the incentive to establish arrangements that result in it being the variable interest holder with power. Joint ventures and franchisees are exempt from this condition. That is, assuming the other conditions below do not exist, a reporting entity that participated significantly in the design or redesign of a joint venture or franchisee is not required to apply the provisions of the Variable Interest Model.

- The 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.

- The reporting entity and its related parties provide more than half of the total equity, subordinated debt and other forms of subordinated financial support to the entity based on an analysis of fair values of the interests in the entity.

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

If a reporting entity qualifies for one of the scope exceptions above, it should consider the voting interest entity provisions of ASC 810 to determine whether consolidation is required. If a reporting entity does not qualify for one of the scope exceptions above, it is within the scope of the Variable Interest Model and must further evaluate the entity for possible consolidation under that model.

3 However, if a reporting entity is using a NFP organization to circumvent the provisions of the Variable Interest Model, that NFP organization would be subject to evaluation for consolidation under the Variable Interest Model.
1.2.3 Step 3. Does the reporting entity have a variable interest in an entity?

A reporting entity must determine whether it has a variable interest in the entity being evaluated for consolidation. Identifying variable interests generally requires a qualitative assessment that focuses on the purpose and design of an entity. To identify variable interests, it helps to take a step back and ask, “Why was this entity created?” “What is the entity’s purpose?” and “What risks was the entity designed to create and distribute?”

To answer these questions, a reporting entity should analyze the entity’s activities, including which parties participated significantly in the design or redesign of the entity, the terms of the contracts the entity entered into, the nature of interests issued and how the entity’s interests were marketed to potential investors. The entity’s governing documents, formation documents, marketing materials and all other contractual arrangements should be closely reviewed and combined with the analysis of the activities of the entity to determine the risks the entity was designed to create and distribute.

Risks that cause variability include, but are not limited to, the following:

- Credit risk
- Interest rate risk (including prepayment risk)
- Foreign currency exchange risk
- Commodity price risk
- Equity price risk
- Operations risk
A reporting entity may be exposed to a number of risks through the interests it holds in an entity, but the Variable Interest Model considers only interests that absorb variability the entity was designed to create and distribute. Keep in mind that when the Variable Interest Model refers to variability, it is referring to returns that are positive, negative or both.

After determining the variability to consider, a reporting entity can then identify which interests absorb that variability. The Variable Interest Model defines variable interests as contractual, ownership (equity) or other financial interests in an entity that change with changes in the fair value of the entity’s net assets. For example, a traditional equity investment is a variable interest because its value changes with changes in the fair value of the company’s net assets. Another example would be a reporting entity that guarantees an entity’s outstanding debt. Similar to an equity investment, the guarantee provides the reporting entity with a variable interest in the entity because the value of the guarantee changes with changes in the fair value of the entity’s net assets.

The labeling of an item as an asset, liability, equity or contractual arrangement does not determine whether that item is a variable interest. Variable interests can be any of these. A key factor distinguishing a variable interest from other interests is its ability to absorb or receive the variability an entity was designed to create and pass along to its interest holders.

### Illustration 1-2: Variable interests — leases

Assume a lessor creates an entity to hold an asset that it leases to a third party (lessee) under an operating lease. The operating lease includes market terms and conditions and does not contain a residual value guarantee, purchase option or other similar features. Also, assume the arrangement does not qualify for the private company accounting alternative to the Variable Interest Model.

**Analysis**

When evaluating this transaction under the Variable Interest Model, the lessee must determine the purpose and design of the entity, including the risks the entity was designed to create and pass through to its variable interest holders. In this example, the entity is designed to be exposed to risks associated with a cumulative change in the fair value of the leased property at the end of the lease term as well as the risk that the lessee will default on its contractually required lease payments. Under this scenario, the lessee does not have a variable interest in the entity because the lessee does not absorb changes in the fair value of the asset through its operating lease. Rather, the lessee introduces risk to the entity through its potential failure to perform.

However, if the lessee guarantees the residual value of the asset or has an option to purchase the asset at a fixed price, the lessee would have a variable interest in the entity. The lessee would absorb decreases in the fair value of the asset through a residual value guarantee or would receive increases in the fair value of the asset through a fixed price purchase option. Because the lessee has a variable interest in the entity, the lessee must evaluate the entity to determine whether the entity is a VIE and whether the lessee is the primary beneficiary of the entity.

Guarantees, subordinated debt interests and written call options are variable interests because they absorb risk created and distributed by the entity. Items such as forward contracts, derivative contracts, purchase or supply arrangements and fees paid to decision makers or service providers may represent variable interests depending on the facts and circumstances. These items require further evaluation and are discussed in detail in Chapter 5 of this publication.
Fees paid to decision makers or service providers

The Variable Interest Model provides separate guidance on determining whether fees paid to an entity’s decision makers or service providers represent variable interests in an entity. Asset managers, real estate property managers and research and development service providers are examples of decision makers or service providers that should evaluate their fee arrangements under this guidance to determine whether they have a variable interest in an entity.

A decision maker or service provider must meet three criteria to conclude that its fees do not represent a variable interest and it is not subject to the Variable Interest Model. The criteria include evaluating whether the fees are customary and commensurate with services provided. A decision maker or service provider also should consider its other interests, including its indirect interests when performing this evaluation. (The criteria are described in detail in Chapter 5 of this publication).

The guidance is intended to allow a decision maker or service provider to determine whether it is acting as a fiduciary or agent rather than as a principal. If a decision maker or service provider meets all three criteria, it is acting as an agent of the entity for which it makes decisions or provides services and therefore would not be subject to consolidation under the Variable Interest Model. If, however, a decision maker or service provider fails to meet any one of the three criteria, it is deemed to be acting as a principal and may need to consolidate the entity.

1.2.4 Step 4. Is the entity a VIE?

A reporting entity that concludes it holds variable interests in an entity, either from fees or other interests, would then ask, “Is the entity a VIE?” The initial determination is made on the date on which a reporting entity becomes involved with the entity, which is generally when a reporting entity obtains a variable interest (e.g., an investment, loan, lease) in the entity.

The distinction between a VIE and other entities is based on the nature and amount of the equity investment and the rights and obligations of the equity investors. For example, consolidation based on a majority voting interest is generally appropriate when the entity has sufficient equity to finance its operations, and the equity investor or investors make the decisions to direct the significant activities of the subsidiary through their equity interests. Entities that fall under the traditional Voting Model have equity investors that expose themselves to variability (i.e., expected residual returns and expected losses) in exchange for control through voting rights.

The Voting Model is not appropriate when an entity does not have sufficient equity to finance its operations without additional subordinated financial support or when decisions to direct significant activities of the entity involve an interest other than the equity interests. If the total equity investment at risk is not sufficient to permit the entity to finance its activities, consolidation based on a majority shareholder vote may not result in the appropriate reporting entity consolidating an entity.

<table>
<thead>
<tr>
<th>Misconception: Variable interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>If a reporting entity has a variable interest in an entity, the entity is a variable interest entity.</td>
</tr>
</tbody>
</table>

A common misconception is that having a variable interest in an entity means the entity is a variable interest entity. It is easy to understand the confusion based on the words alone. However, a reporting entity can have a variable interest (e.g., shares of stock, a fee, a guarantee) in an entity without the entity being a VIE if the entity does not have any of the characteristics of a VIE (e.g., lack of sufficient equity at risk). If an entity is not a VIE, the entity is a voting interest entity, and consolidation based on voting interests is appropriate. It is the nature and amount of equity interests and the rights and obligations of equity investors that distinguish a VIE from other entities.
An entity is a VIE if it has any of the following characteristics:

- The entity does not have enough equity to finance its activities without additional subordinated financial support.
- The equity holders, as a group, lack the characteristics of a controlling financial interest.
- The entity is structured with non-substantive voting rights (i.e., an anti-abuse clause).

Lack of sufficient equity at risk

An entity is a VIE if the equity at risk is not sufficient to permit the entity to carry on its activities without additional subordinated financial support. That is, if the entity does not have enough equity to induce lenders or other investors to provide the funds necessary at market terms for the entity to conduct its activities, the equity is not sufficient and the entity is a VIE. As an extreme example, an entity that is financed with no equity is a VIE. An entity financed with some amount of equity also may be a VIE pending further evaluation.

When measuring whether equity is sufficient for an entity to finance its operations, only equity investments at risk should be considered. “Equity” means an interest that is required to be reported as equity in that entity’s US GAAP financial statements. That is, equity instruments classified as liabilities under US GAAP are not considered equity in the Variable Interest Model.

### Misconception: Equity investment at risk

A commitment to fund equity is considered an equity investment at risk.

Some make the mistake of considering a commitment to fund equity in the future an equity investment at risk. A commitment to fund equity is not reported as equity in the US GAAP balance sheet of the entity under evaluation. As a result, the instrument is not an equity investment at risk when determining whether the entity has sufficient equity. To qualify as an equity investment at risk, the interest must (1) represent equity under US GAAP and (2) be at economic risk.

Equity “at risk”:

- Includes only equity investments in the entity that participate significantly in both profits and losses. If an equity interest participates significantly in only profits or only losses, the equity is not at risk. Carefully consider the presence of any put or call options.
- Excludes equity interests that were issued by the entity in exchange for subordinated interests in other VIEs.
- Excludes amounts (e.g., fees or charitable contributions) provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity.
- Excludes amounts financed for the equity holder (e.g., by loans or guarantees of loans) directly by the entity or by other parties involved with the entity.

In summary, only GAAP equity that is at risk is included in the evaluation of whether an entity's equity is sufficient to finance its operations (see Chapter 7).

Once a reporting entity determines the amount of GAAP equity that is at economic risk, the reporting entity must determine whether that amount of equity is sufficient for the entity to finance its activities without additional subordinated financial support. This can be demonstrated in one of three ways:

1. by demonstrating that the entity has the ability to finance its activities without additional subordinated financial support;
2. by having at least as much equity as a similar entity that finances its operations with no additional subordinated financial support; or
3. by comparing the entity's at-risk equity investment with its calculated expected losses.
Often, the determination of the sufficiency of equity is qualitative. A reporting entity can demonstrate that the amount of equity in an entity is sufficient by evaluating whether the entity has enough equity to induce lenders or other investors to provide the funds necessary for the entity to conduct its activities. For example, recourse financing or a guarantee on an entity’s debt are qualitative factors that indicate an entity may not have sufficient equity to finance its activities without additional subordinated financial support.

In certain circumstances, a reporting entity may be required to perform a quantitative analysis. An entity’s expected losses are not GAAP or economic losses expected to be incurred by an entity, and expected residual returns are not GAAP or economic income expected to be earned by an entity. Rather, these amounts are derived using projected cash flow techniques as described in CON 7. CON 7 requires expected cash flows to be derived by projecting multiple outcomes and assigning each possible outcome a probability weight. The multiple outcomes should be based on projections of possible economic outcomes under different scenarios. The scenarios are based on varying the key assumptions that affect the entity’s results of operations or the fair value of its assets and result in changes to the returns available to the entity’s variable interest holders. The calculation of expected losses and expected returns may require the assistance of valuation professionals. (The calculation is described in Appendix A of this publication.)

### Misconception: Sufficiency of equity investment at risk

An equity investment at risk that is greater than 10% of an entity’s total assets is sufficient.

The Variable Interest Model includes a presumption that an equity investment at risk of less than 10% of an entity’s total assets is not sufficient to permit the entity to finance its activities without subordinated financial support. As a result, some mistakenly assume the reverse to be true (i.e., that an equity investment at risk of greater than 10% of the entity’s total assets is sufficient to meet the equity at-risk criterion). The FASB intends the 10% presumption to apply in one direction only.

Because less than a 10% equity investment at risk is presumed to be insufficient (unless the equity investment can be demonstrated to be sufficient), and the Variable Interest Model specifies that an equity investment of 10% or greater does not relieve a reporting entity of its responsibility to determine whether it requires a greater equity investment, we do not believe that the 10% presumption is relevant. Rather, we believe that the sufficiency of a reporting entity’s equity investment at risk must be demonstrated in all cases through one of the three methods described above.

### Lack of a controlling financial interest

For an entity not to be a VIE, the at-risk equity holders – as a group – must have all of the following characteristics of a controlling financial interest:

- The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance
- The obligation to absorb an entity’s expected losses
- The right to receive an entity’s expected residual returns

### Ability to make decisions and the consideration of kick-out rights and participating rights

Power means having the ability, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance (e.g., the entity’s revenues, expenses, margins, gains and losses, cash flows, financial position). Significant activities may include purchasing or selling significant assets, incurring additional debt, making acquisition and/or divestiture decisions or determining the strategic operating direction of the entity. While an entity’s operations may involve a number of activities, a subset of those activities is generally considered significant to the entity’s economic performance. A reporting entity should carefully evaluate the purpose and design of an entity to determine the entity’s significant activities. It helps to ask, “Why was this entity created?” and “What is the entity’s purpose?”
It's important to note that the Variable Interest Model does not require each individual equity holder to have power to make the key decisions. Instead, the equity holders as a group must possess that power. If holders of interests that are not equity investments at risk have the ability to participate in decision making with respect to the activities that significantly impact the economic performance of the entity, the entity is a VIE.

**Misconception:** Directing the activities of an entity

A reporting entity directs the activities that most significantly impact an entity's economic performance through interests other than equity interests, but the entity is not a VIE because the reporting entity holds equity in it.

For an entity not to be a VIE, the equity holder(s) has to demonstrate power through its ability to vote an equity investment at risk and not through other interests. Other interests held by the holder(s) of an equity investment at risk may not be combined with equity interests in determining whether the entity is a VIE.

**Illustration 1-3:** Power through other interests

Assume a corporation is created by three unrelated parties to distribute a product. One of the at-risk equity holders has distribution management experience and is hired by the corporation as the operations manager. Each equity holder receives one seat on the entity's board of directors, and all board decisions require a simple-majority vote of the three board members. With respect to operations, the equity holders have protective rights and cannot remove the operations manager without cause.

Assume that the operations manager has a variable interest in the entity through the fees it receives as the operations manager. The management contract gives the operations manager power over all of the entity's significant decisions.

**Analysis**

In this example, the power rests with the operations manager by virtue of the management agreement rather than through its equity interest. Therefore, the entity would be a VIE because no decision making for the entity is embodied in the equity interests.

When evaluating whether a limited partnership or similar entity is a VIE, the analysis must be focused on the presence of substantive kick-out rights or participating rights. The FASB views the rights held by limited partners in a partnership as analogous to voting shares in a corporation. Therefore, when determining whether the at-risk equity holders have power over a limited partnership (or other similar entity), the assessment will focus on whether the limited partners hold substantive kick-out rights or participating rights.

That is, assuming the other two characteristics of a VIE are not met, a limited partnership or similar entity will be evaluated for consolidation under the voting model if either of the following conditions exist:

- A single limited partner, partners with a simple majority of voting interests or partners with a smaller voting interest with equity at risk are able to exercise substantive kick-out rights or
  - Limited partners with equity at risk are able to exercise substantive participating rights.

A kick-out right is 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 entity without cause. A participating right is the ability to block the actions through which a reporting entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance.
Illustration 1-4: Simple majority of kick-out rights

A limited partnership is formed to develop commercial real estate. The partnership has three limited partners and each of them holds a 32% equity investment in the fund. These investments are considered equity investment at risk. The general partner holds 4% of the equity interest in the partnership. The general partner makes the day-to-day decisions, but a simple majority of the limited partners voting interests can remove the general partner without cause (assume the kick-out right is substantive).

Analysis

The entity would not be a VIE because partners with a simple majority of voting rights have the ability to remove the general partner.

It is important to note that kick-out rights must be substantive to be considered in the analysis. For example, if a kick-out right is not substantive because of barriers to exercise – it is not factored into the analysis.

The FASB has affirmed that participating rights are substantively similar to kick-out rights and thus should be subject to the same restrictions as kick-out rights.

For purposes of the Variable Interest Model, a “single party” in the VIE assessment includes a reporting entity and its related parties or de facto agents. For additional guidance on related parties and de facto agents, see Chapter 10 of this publication.

Obligation to absorb expected losses or the right to receive the residual returns

A characteristic of a traditional equity investment is that the holder participates in both profits and losses as described above. Therefore, holders of the equity investment at risk, as a group, cannot be shielded from the risk of loss by the entity or by other parties involved with the entity. Their returns also cannot be capped by the entity’s governing documents or arrangements with other variable interest holders of the entity. A reporting entity should carefully consider whether puts, calls, guarantees or other terms and conditions are present in arrangements that limit its equity holders’ obligation to absorb losses or receive benefits.

Entity established with non-substantive voting rights

The last criterion to consider when evaluating whether an entity is a VIE is whether the entity was established with non-substantive voting rights. This criterion is known as the anti-abuse test. Under this test, an entity is a VIE if (1) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their right to receive the expected residual returns or both and (2) substantially all of the entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights, including its related parties and certain de facto agents.

Illustration 1-5: Anti-abuse test

Assume Company A, a manufacturer, and Company B, a financier, establish an entity. The entity agreement states that the entity may purchase only Company A’s products. Company A’s and Company B’s economic interests in the entity are 70% and 30%, respectively. Further assume that Company B has 51% of the outstanding voting rights.

Analysis

In this case, we believe that the entity is a VIE because substantially all of the entity’s activities (i.e., buying Company A’s products) are conducted on behalf of Company A, whose economic interest exceeds its voting rights.
Disproportionate interest does not, in and of itself, lead to a conclusion that an entity is a VIE. Substantially all of an entity’s activities must involve or be conducted on behalf of the investor that has disproportionately few voting rights for an entity to be a VIE, which in the above example is Company A (i.e., Company A has 70% of the economic interests and 49% of the votes). Evaluating whether substantially all of an entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights requires the use of professional judgment. (Factors to consider are included in Chapter 7 of this publication.)

1.2.5 Step 5. If the entity is a VIE, is the reporting entity the primary beneficiary?

To recap where we are in the model, a reporting entity that has concluded that it is in the scope of the Variable Interest Model, that it has a variable interest in an entity and that the entity is a VIE must evaluate whether it is the primary beneficiary of the VIE. The primary beneficiary analysis is a qualitative analysis based on power and benefits. A reporting entity has a controlling financial interest in a VIE and must consolidate the VIE if it has both power and benefits — that is, it has (1) the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance (power) and (2) the obligation to absorb losses of the VIE that potentially could be significant to the VIE or the right to receive benefits from the VIE that potentially could be significant to the VIE (benefits).

Benefits

If a reporting entity has concluded it has a variable interest, it likely will meet the benefits criterion. If a reporting entity has a variable interest in a VIE, we believe there is a presumption that the reporting entity has satisfied the benefits criterion. We believe that it would be uncommon for a reporting entity to conclude that it has a variable interest but does not have benefits. Having a variable interest generally will expose a reporting entity to either losses or returns that potentially could be significant to the VIE. The key word in this analysis is “could.” The benefits criterion is not based on probability. It requires only that a reporting entity have the obligation to absorb losses or the right to receive benefits that could be significant. Also, a reporting entity does not have to have both the obligation to absorb losses and the right to receive benefits. The reporting entity only has to be exposed to one or the other.

An entity that receives a fee from a VIE will determine if such fee should be included when performing the primary beneficiary analysis. To determine whether a reporting entity satisfies the benefits criterion, it will exclude fee arrangements that meet both of the following conditions:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The compensation arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated on an arm’s-length basis.

Power

To consolidate an entity under the Variable Interest Model, a reporting entity must have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance (e.g., the VIE’s revenues, expenses, margins, gains and losses, cash flows, financial position). The following graphic illustrates how to think systematically about the power assessment:
A reporting entity should carefully evaluate the purpose and design of an entity to determine the entity’s significant activities. While an entity’s operations may involve a number of activities, generally a subset of those activities is considered significant to the entity’s economic performance. A reporting entity’s involvement with the design of a VIE does not, itself, establish the reporting entity as the party with power, even if that involvement is significant. Rather, 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 power.

The same activities that were considered in determining whether the equity holders have power for the VIE test will be considered for identifying the primary beneficiary. However, now the focus is on identifying which party has the power. It may or may not be an equity holder. As a reminder, significant activities may include, but are not limited to, purchasing or selling significant assets, incurring additional indebtedness, making acquisition and/or divestiture decisions or determining the strategic operating direction of the entity.

After the activities that have the most significant impact on the VIE’s economic performance have been identified, a reporting entity evaluates whether it has the power to direct those activities. Power may be exercised through the board of directors, management, a contract or other arrangements. A reporting entity’s ability to direct the activities of a VIE when circumstances arise or events occur constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. It is important to note that a reporting entity does not actively have to exercise its power to have power to direct the activities of an entity.

The FASB has acknowledged that multiple reporting entities may meet the benefits criterion but only one reporting entity could have the characteristic of power as defined in the Variable Interest Model. Thus, this characteristic would not result in a reporting entity identifying more than one party as the primary beneficiary. However, in some circumstances (e.g., shared power among unrelated parties), a reporting entity may conclude that no one party has the power over a VIE.

### Misconception: Primary beneficiary

A reporting entity that absorbs a majority of an entity’s expected losses, receives a majority of the entity's expected residual returns, or both is the primary beneficiary of the VIE.

Some mistakenly focus on economics when trying to determine whether a reporting entity is the primary beneficiary of a VIE. Under FIN 46(R) the primary beneficiary test was quantitative. A reporting entity would consolidate a VIE if that reporting entity had a variable interest (or combination of variable interests) that would absorb a majority of the VIE’s expected losses, receive a majority of the VIE’s expected residual returns, or both. However, ASU 2009-17 amended the primary beneficiary test to make it a qualitative assessment that focuses on power and benefits. While a reporting entity still considers economics (i.e., the obligation to absorb losses or the right to receive benefits), the primary beneficiary is the party with power.
A reporting entity first determines whether it individually has the power to direct the activities of the VIE that most significantly impact the entity’s economic performance and also has the obligation to absorb losses or the right to receive benefits of the VIE that potentially could be significant to the VIE. That is, a reporting entity should ask itself whether it has both power and benefits. If the reporting entity has both power and benefits, it consolidates the entity under the Variable Interest Model.

**Related parties and de facto agents**

The Variable Interest Model has specific steps and provisions which require consideration with respect to related parties. If a reporting entity concludes that neither it nor one of its related parties individually meets the criteria to be the primary beneficiary, the reporting entity then evaluates whether as a group, the reporting entity and its related parties have those characteristics. When a related party group has power and benefits, further analysis is required to determine if one party within the group is the primary beneficiary. See Chapter 9 of this publication for further details.

For purposes of the Variable Interest Model, the term “related parties” includes parties identified in ASC 850 and certain other parties that are acting as de facto agents of the variable interest holder. For additional guidance on related parties and de facto agents, see Chapter 10 of this publication.

**Shared power**

Power can be shared by a group of unrelated parties. If a reporting entity determines that is the case and no one party has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, there is no primary beneficiary. Power is shared if each of the unrelated parties is required to consent to the decisions relating to the activities that significantly impact the VIE’s economic performance. The governance provisions of an entity should be evaluated to ensure that the consent provisions are substantive.

**Illustration 1-6: Shared power**

Assume that three unrelated parties form an entity (which is a VIE) to manufacture, distribute and sell beverages. Each party has one-third of the voting rights, and each has one seat on the board of directors. All significant decisions are taken to the board of directors for approval. Decisions are made by the board of directors based on the unanimous consent of all three parties.

Analysis

The VIE does not have a primary beneficiary because no one party has the power to direct the activities that most significantly impact the economic performance of the entity. In this case, no one consolidates the VIE.

However, if all three parties are related or have de facto agency relationships, one of the parties must be identified as the primary beneficiary (because collectively they have power). The Variable Interest Model’s related party provisions would be used to determine which party is the primary beneficiary of the entity.

If a reporting entity concludes that power is not shared but the activities that most significantly impact the VIE’s economic performance are directed by multiple parties and each party directs the same activities as the others, the party with the power over the majority of the activities, if any, is the primary beneficiary of the VIE (provided it has benefits). If no party has the power over the majority of the activities, there is no primary beneficiary. See Chapter 8 of this publication for further details.
However, if power is not shared but the activities that most significantly impact the VIE’s economic performance are directed by multiple parties, and each party performs different activities, a reporting entity must identify the party that has the power to direct the activities that most significantly impact the entity’s economic performance. That is, one party has the power. For example, a party may decide there are four decisions that most significantly impact a VIE’s economic performance. If one party makes two decisions and another party makes the other two decisions, the parties must effectively put the decisions on a scale and decide which party is directing the activities that most significantly impact the VIE’s economic performance. To determine which party is the primary beneficiary in these circumstances will require a reporting entity to evaluate the purpose and design of the entity and to consider other factors that may provide insight into which entity has the power. See Chapter 8 of this publication for further details.

**Kick-out rights, participating rights or protective rights**

As part of its power assessment, a reporting entity also should consider whether kick-out rights, participating rights or protective rights are present. The following chart defines these rights and describes how a reporting entity should consider each right in the primary beneficiary assessment.

<table>
<thead>
<tr>
<th>Rights</th>
<th>Definition</th>
<th>Considerations</th>
</tr>
</thead>
</table>
| Kick-out rights | 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 liquidate (dissolve) the entity. | • Consider in primary beneficiary analysis if held by a single party, including related parties and de facto agents  
• May provide the holder of such rights with power  
• Must be substantive |
| Participating rights | The ability to block the actions through which a reporting entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance (i.e., veto rights). | • Consider in primary beneficiary analysis if held by a single party, including related parties and de facto agents  
• Generally, do not provide the holder of such rights with power |
| Protective rights | 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. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. They could be approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity’s economic performance. A protective right could also be 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. | • Do not provide the holder of such rights with power and do not preclude another party from having power  
• Consider in analysis to distinguish a participating right from a protective right, which will require the use of professional judgment |

In determining whether a reporting entity has power, a reporting entity should not consider kick-out rights unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise such rights. In those circumstances, a single reporting entity (including its related parties and de facto agents) that has the unilateral ability to exercise such rights may be the reporting entity with the power.
Overview

1. Financial reporting developments

Consolidation and the Variable Interest Model

Illustration 1-8: Unilateral kick-out right

Assume two unrelated parties (Party A and Party B) form an entity that is a VIE. The parties identify three activities (e.g., operating budget, capital expenditures and incurring debt) that most significantly impact the VIE’s economic performance. Party A, the manager, is responsible for making decisions about all three activities, but Party B holds 100% of the equity at risk and has a substantive kick-out right to remove and replace Party A without cause.

Analysis

In this case, we believe that Party B likely would be the primary beneficiary of the VIE and therefore would consolidate the VIE because Party B’s unilateral kick-out right negates Party A’s decision-making ability.

A reporting entity should not consider participating rights unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights. However, participating rights held by a single reporting entity generally do not provide the holder of those rights with power but may preclude another party from having the power.

Illustration 1-9: Unilateral participating right

Assume two unrelated parties (Party A and Party B) form an entity that is a VIE. They identify three activities (e.g., operating budget, capital expenditures and incurring debt) that most significantly impact the VIE’s economic performance. Party A is responsible for making decisions about all three activities, but Party B has participating rights over all three decisions.

Analysis

We believe that the participating rights do not provide Party B with power over the VIE but likely would preclude Party A from having the power. In this case, it is possible that neither party would consolidate the VIE.

However, if Party B had participating rights over two of the three decisions but Party A had the unilateral right to direct the third significant activity, we believe Party A would have the power and therefore would consolidate the VIE.

Protective rights held by other parties do not provide the holder of such rights with power and do not preclude a reporting entity from having the power. However, careful evaluation is required to distinguish a participating right from a protective right.

1.3 Summary

When applying the Variable Interest Model, remember to ask the questions discussed in this chapter. Also, carefully consider any related party or de facto agency relationships where required.

In summary, if a reporting entity concludes it is the primary beneficiary of an entity, the reporting entity would consolidate the entity by following the consolidation guidance in ASC 810. If the reporting entity concludes it is not the primary beneficiary, it does not consolidate.
2 Definitions of terms

Following are some important terms relevant to the application of the Variable Interest Model and our observations about them:

2.1 Legal entity

<table>
<thead>
<tr>
<th><strong>Excerpt from Accounting Standards Codification</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidation — Overall</strong></td>
</tr>
<tr>
<td><strong>Glossary</strong></td>
</tr>
<tr>
<td>810-10-20</td>
</tr>
<tr>
<td><strong>Legal Entity</strong></td>
</tr>
</tbody>
</table>

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.

All legal entities, with limited exceptions, are subject to consolidation by a reporting entity under the Variable Interest Model or Voting Model (see Chapter 4).

A “series company” is a type of structure that is common in the asset management industry. It is typically formed as a single corporation or state business trust established under one set of organizational documents and a single board of directors or trustees, but offers investors several funds (series funds) in which they can invest. See Section 4.2.7 for guidance on the determination of whether a series fund should be treated as a separate legal entity under the Variable Interest Model.

2.2 Controlling financial interest

<table>
<thead>
<tr>
<th><strong>Excerpt from Accounting Standards Codification</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidation — Overall</strong></td>
</tr>
<tr>
<td><strong>Objectives — General</strong></td>
</tr>
<tr>
<td>810-10-10-1</td>
</tr>
<tr>
<td><strong>Scope and Scope Exceptions — General</strong></td>
</tr>
<tr>
<td>810-10-15-8</td>
</tr>
</tbody>
</table>

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.

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.

Under the Voting Model, the determining factor for a controlling financial interest is the ownership of a majority voting interest in a corporation or a majority of kick-out rights in a limited partnership (see Appendix C for more guidance). However, as structures or arrangements have evolved over time, the Voting Model has not always been effective in identifying controlling financial interests in entities that are controlled through other means.

Under the Variable Interest Model, a controlling financial interest is determined based on which reporting entity, if any, has (1) the power to direct the activities of a VIE that most significantly impact 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. This power to direct the significant activities of a VIE could be through a variety of equity, contractual or other interests, collectively known as “variable interests.”

### 2.3 Common control

US GAAP does not define the term “common control.” The Emerging Issues Task Force in EITF Issue No. 02-5, Definition of “Common Control” in Relation to FASB Statement No. 141 (EITF 02-5), discussed, but did not reach a consensus, on the issue of how to determine whether separate entities are under common control. EITF 02-5 summarizes the criteria for determining whether common control exists based on a 1997 speech by the SEC staff. Although EITF 02-5 was not codified, the guidance from this speech has been applied in practice by SEC registrants and the SEC observer to the EITF noted that SEC registrants would be expected to continue to apply that guidance. Specifically, EITF 02-5 indicates that common control exists only in the following situations:

- An individual or entity holds more than 50% of the voting ownership interest of each entity.
- Immediate family members hold more than 50% of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert). Immediate family members include a married couple and their children, but not the married couple’s grandchildren. Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration of the substance of the ownership and voting relationships.
- A group of shareholders holds more than 50% of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities’ shares in concert exists.

With respect to immediate family member relationships in the second bullet above, we understand that this set of relationships should be construed literally and should not be expanded. For example, shares held by in-laws should not be considered by analogy as held under common control. Due to the lack of other authoritative guidance, the SEC’s guidance is widely applied by public and nonpublic companies. Judgment is required to determine whether common control exists in situations other than those described above.

---

ASC 805-50 also provides examples of the types of transactions that qualify as common control transactions.

**Excerpt from Accounting Standards Codification**

*Business Combinations – Related Issues*

**Scope and Scope Exceptions**

**805-50-15-6**

The guidance in the Transactions Between Entities Under Common Control Subsections applies to combinations between entities or businesses under common control. The following are examples of those types of transactions:

a. An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity.

b. A parent transfers the net assets of a wholly owned subsidiary into the parent and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.

c. A parent transfers its controlling interest in several partially owned subsidiaries to a new wholly owned subsidiary. That also is a change in legal organization but not in the reporting entity.

d. A parent exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares issued by the parent’s less-than-wholly-owned subsidiary, thereby increasing the parent’s percentage of ownership in the less-than-wholly-owned subsidiary but leaving all of the existing noncontrolling interest outstanding.

e. A parent’s less-than-wholly-owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange. That is not a business combination from the perspective of the parent.

f. A limited liability company is formed by combining entities under common control.

g. Two or more not-for-profit entities (NFPS) that are effectively controlled by the same board members transfer their net assets to a new entity, dissolve the former entities, and appoint the same board members to the newly combined entity.

The list of examples above is not all-inclusive. Although the examples above are primarily parent-subsidiary transactions, common control transactions also include transfers or exchanges between subsidiaries directly or indirectly controlled by the same parent or controlling shareholder.

Transfers among entities with a high degree of common ownership are not necessarily common control transactions. When two or more entities have shareholders in common but no one shareholder (after taking into account immediate family member relationships and the existence of contemporaneous written agreements) controls the entities, the entities have common ownership but not common control.

In ASC 805, “control” has the same meaning as a “controlling financial interest” (see Section 2.2), which would include control under the Voting Model and under the Variable Interest Model. Therefore, all forms of control are considered in determining if entities are under common control. That is, entities that would be consolidated by the same reporting entity are considered to be under common control.

See additional guidance on common control in Section C of our FRD, *Business combinations.*
2.4 Decision maker and decision-making authority

Excerpt from Accounting Standards Codification
Consolidation – Overall
Glossary
810-10-20
Decision Maker
An entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity’s economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Decision-Making Authority
The power to direct the activities of a legal entity that most significantly impact the entity’s economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Under the Variable Interest Model, the reporting entity that has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance (e.g., the VIE’s revenues, expenses, margins, gains and losses, cash flows, financial position) is the “decision maker.” The power held by that reporting entity is referred to as “decision-making authority.”

2.5 Power

The term “power” is not defined in consolidation guidance, but for a VIE, it refers to the ability to direct activities of a VIE that most significantly impact the VIE’s economic performance, when those events or circumstances arise. A reporting entity does not have to exercise its power to have power. A reporting entity must have power, in addition to benefits, to be the primary beneficiary of a VIE. Power stems from decision-making authority. To identify which reporting entity, if any, has power over a VIE, perform the following steps:

- Consider purpose and design of the entity;
- Identify the activities that most significantly impact economic performance;
- Identify how decisions about the significant activities are made;
- Identify the party or parties that make the decisions about the significant activities; consider kick-out rights, participating rights or protective rights.

See Section 7.3 for more guidance.

2.6 Expected losses, expected residual returns and expected variability

Excerpt from Accounting Standards Codification
Consolidation – Overall
Glossary
810-10-20
Expected Losses
A legal entity that has no history of net losses and expects to continue to be profitable in the foreseeable future can be a variable interest entity (VIE). A legal entity that expects to be profitable will have expected losses. A VIE’s expected losses are the expected negative variability in the fair value of its net assets exclusive of variable interests and not the anticipated amount or variability of the net income or loss.
2 Definitions of terms

**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.

An entity’s expected losses and expected residual returns are defined as the negative or positive variability in the fair value of an entity’s net assets, exclusive of variable interests.

The concepts of expected losses and expected residual returns are difficult aspects of the Variable Interest Model to understand and to apply. This difficulty arises primarily because expected losses are neither GAAP nor economic losses expected to be incurred by the entity and expected residual returns are defined as amounts derived from techniques described in CON 7 and are not determined by GAAP income or loss. CON 7 requires expected cash flows to be derived by projecting possible outcomes and assigning each possible outcome a probability weight. Under the Variable Interest Model, expected losses and expected residual returns represent the potential for variability in each outcome from the expected (or mean) outcome. Outcomes that exceed the expected outcome give rise to expected residual returns (over-performance or positive variability), while outcomes that are less than the expected outcome give rise to expected losses (under-performance or negative variability).

The Variable Interest Model also provides that expected losses and expected residual returns represent amounts discounted and otherwise adjusted for market factors and assumptions, rather than undiscounted cash flow estimates.

The concept of expected losses and expected residual returns is described further in Section 5.1 and Appendix A of this publication.

2.7 **Indirect interest (Updated February 2016)**

ASC 810-10-55-37D introduces the concept of an “indirect” interest when evaluating interests held by related parties (or de facto agents), to determine whether such interests cause a decision maker’s or service provider’s fees to be considered a variable interest. To have an indirect interest, a decision maker or service provider must have a direct variable interest in a related party that has a variable interest in an entity. See Section 5.4.13.2.1 for additional guidance.

The FASB has a project to clarify how a decision maker or service provider evaluates an indirect interest in an entity. The Board has tentatively decided to amend the guidance in ASC 810-10-25-42 by deleting the last sentence of that paragraph, which states “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 Board also directed the staff to consider whether any amendments to the guidance in ASC 810 for fees paid to decision makers or service providers were necessary as a result of the proposed change. We encourage readers to monitor developments in this area.

2.8 Kick-out rights and liquidation rights

Excerpt from Accounting Standards Codification

Consolidation — Overall

Glossary

810-10-20

Kick-out rights (VIE definition)

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.

With Cause

With cause generally restricts the limited partners' ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that are not limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.

Without Cause

Without cause means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners.

Under the Variable Interest Model, kick-out rights represent the ability to remove or “kick-out” the decision maker or service provider. When kick-out rights are present in an arrangement, they should be evaluated to determine whether or not they are substantive. If such rights are substantive, they are considered in determining whether an entity is a VIE and identifying which party, if any, is the primary beneficiary of a VIE. If the kick-out right is not substantive, for example because of barriers to exercise, it is not factored into the analysis.

Agreements may provide for the removal of the decision maker or service provider only when a performance condition or other threshold has not been met. The performance condition's terms should be analyzed in these circumstances to determine whether it represents “cause.” We believe that the determination of whether a performance requirement represents “cause” should be made when the decision maker or service provider becomes involved with the entity and generally should not be assessed on an ongoing basis unless there has been a substantive change in the purpose and design of the entity.

As discussed in paragraph 49 of the Basis for Conclusions to ASU 2015-02, liquidation rights should be considered equivalent to kick-out rights. Liquidation rights provide the holders of such rights with the ability to dissolve the entity and, thus, effectively remove the decision maker's or service provider's authority. However, the barriers to exercise a liquidation right may differ from the barriers to exercise a kick-out right. Therefore, appropriate consideration should be given to those barriers when assessing whether the liquidation rights are substantive.

See Chapters 7 and 8 for a detailed discussion of kick-out rights and their effect on the determination of a VIE and primary beneficiary, respectively.
2.9 Participating rights

Excerpt from Accounting Standards Codification
Consolidation – Overall
Glossary
810-10-20
Participating rights (VIE definition)
The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Under the Variable Interest Model, participating rights represent the ability to participate in or block the actions through which a reporting entity exercises its decision-making authority.

When participating rights are present in an arrangement, they should be considered in determining whether an entity is a VIE and identifying which party, if any, is the primary beneficiary of a VIE. Participating rights generally do not provide the holder of those rights with power but may preclude another party from having power. Participating rights do not require the holders of such rights to have the ability to initiate actions. Significant judgment is required to distinguish a participating right from a protective right. See Chapters 7 and 8 for a detailed discussion of participating rights and their effect on the determination of a VIE and primary beneficiary, respectively.

2.10 Protective rights

Excerpt from Accounting Standards Codification
Consolidation – Overall
Glossary
810-10-20
Protective rights (VIE definition)
Rights designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. For example, they include any of the following:

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

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

c. Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict certain activities of the entity but may not give the franchisor a controlling financial interest in the franchisee. Such rights may only protect the brand of the franchisor.
Under the Variable Interest Model, protective rights are designed only to protect the interests of the party holding those rights. These rights do not provide the holder of such rights with power and do not preclude another reporting entity from having power.

Significant judgment is required to distinguish a protective right from a participating right. While both represent an approval or veto right, a distinguishing factor is the underlying activity or action to which the right relates. As the definition states, protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. Participating rights, on the other hand, involve the ability to approve or veto the activities that most significantly impact an entity’s economic performance. Depending on the facts and circumstances, rights that are protective in the case of one reporting entity may not be protective in the case of another reporting entity.

See Appendix C.3.2.2 for details of protective rights under the Voting Model.

### 2.11 Primary beneficiary

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Glossary**

**810-10-20**

**Primary Beneficiary**

An entity that consolidates a variable interest entity (VIE). See paragraphs 810-10-25-38 through 25-38G for guidance on determining the primary beneficiary.

A reporting entity has a controlling financial interest in a VIE and is, therefore, the primary beneficiary of a VIE if it has (1) the power to direct activities of a VIE that most significantly impact 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. A VIE can have only one primary beneficiary. A VIE may not have a primary beneficiary if no party meets the criteria described above. See Chapters 8 and 9 for guidance on the identification of the primary beneficiary.

### 2.12 Related parties and de facto agents

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Glossary**

**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.

**Recognition – Variable Interest Entities**

**810-10-25-43**

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

a. A party that cannot finance its operations without subordinated financial support from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary.

b. A party that received its interests as a contribution or a loan from the reporting entity.

c. An officer, employee, or member of the governing board of the reporting entity.

d. A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party’s ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.

e. A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.

For purposes of the Variable Interest Model, the term “related parties” includes parties identified in ASC 850 and certain other related parties that are acting as de facto agents of the variable interest holder unless otherwise specified. See Chapter 10 for a detailed discussion of related parties and de facto agents.

**2.13 Subordinated financial support**

*Excerpt from Accounting Standards Codification*

**Consolidation – Overall**

**Glossary**

**810-10-20**

**Subordinated Financial Support**

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 some or all of an entity’s expected losses (i.e., negative variability). It does not refer solely to equity interests, subordinated debt or other forms of financing that are subordinate to other senior interests in the entity. Subordinated financial support could be provided to an entity in many ways, including:

- Equity interests – both common and preferred
- Debt – subordinated and senior
- Contracts with terms that are not market-based
- Guarantees
- Derivatives
- Commitments to fund losses

In general, all forms of debt financing are “subordinated financial support” unless the financing is the most senior class of liabilities and is considered investment grade. Investment grade means a rating that indicates that debt has a relatively low risk of default. If the debt is not rated, it should be considered investment grade only if it possesses characteristics that warrant such a rating.

### 2.14 Variable interest entity

**Excerpt from Accounting Standards Codification**

**Consolidation – Overall**

**Glossary**

**810-10-20**

**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 an entity that does not qualify for a scope exception from the Variable Interest Model and is subject to consolidation based on the Variable Interest Model. An entity is a VIE if it has any of the following characteristics: (1) the entity does not have enough equity to finance its activities without additional subordinated financial support, (2) the at-risk equity holders, as a group, lack the characteristics of a controlling financial interest or (3) the entity is structured with non-substantive voting rights (i.e., an anti-abuse clause). The distinction between a VIE and other entities is based on the nature and amount of the equity investment and the rights and obligations of the equity investors. See Chapter 4 for scope exceptions to the Variable Interest Model and Chapter 7 for determining whether an entity is a VIE.

### 2.15 Variable interests

**Excerpt from Accounting Standards Codification**

**Consolidation – Overall**

**Glossary**

**810-10-20**

**Variable Interests**

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.

See Chapter 5 for a detailed discussion of variable interests.

2.16 Collateralized financing entity

Excerpt from Accounting Standards Codification
Consolidation – Overall
Glossary
810-10-20
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).

ASC 810 defines a collateralized financing entity (CFE) and provides a measurement alternative to ASC 820 for reporting entities that consolidate qualifying CFEs. Under the alternative, the entity may elect to measure both the CFE's financial assets and financial liabilities using the fair value of either the CFE's financial assets or financial liabilities, whichever is more observable. The guidance is aimed at eliminating the measurement difference that sometimes arises when a CFE's financial assets and financial liabilities are independently measured at fair value, as required by ASC 820. See Appendix E for further guidance.

2.17 Voting interest entity

The term “voting interest entity” is not defined in consolidation guidance, but it has emerged in practice to mean an entity that is not a VIE. In a voting interest entity, (1) the equity investment is deemed sufficient to absorb the expected losses of the entity, (2) the at-risk equity holders, as a group, have all of the characteristics of a controlling financial interest and (3) the entity is structured with substantive voting rights. As a result, voting rights are the key driver for determining which party, if any, should consolidate the entity. See Appendix C for details on the Voting Model.

2.18 Private company

Excerpt from Accounting Standards Codification
Consolidation – Overall
Glossary
810-10-20
Private Company
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.
Private Companies can choose to be exempt from applying the Variable Interest Model to lessors in common control leasing arrangements that meet certain criteria. A private company is any entity that is not a public business entity (see Section 2.19), a not-for-profit entity or an employment benefit plan within the scope of ASC 960 through 965 on plan accounting. See Section 4.4.5 and Appendix D for further information.

2.19 Public business entity

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidation – Overall</td>
</tr>
<tr>
<td><strong>Glossary</strong></td>
</tr>
<tr>
<td>810-10-20</td>
</tr>
<tr>
<td><strong>Public Business Entity</strong></td>
</tr>
<tr>
<td>A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.</td>
</tr>
<tr>
<td>a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).</td>
</tr>
<tr>
<td>b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.</td>
</tr>
<tr>
<td>c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.</td>
</tr>
<tr>
<td>d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.</td>
</tr>
<tr>
<td>e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including 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.</td>
</tr>
</tbody>
</table>

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 FASB has defined the term “public business entity” (PBE) and is using that definition for determining whether an entity is eligible to adopt accounting alternatives developed by the Private Company Council (PCC) or use other types of private company relief (e.g., disclosure, transition, effective date) that the FASB provides in new standards.

One PCC alternative allows private companies to choose to be exempt from applying the Variable Interest Model to lessors in common control leasing arrangements that meet certain criteria. See Section 4.4.5 and Appendix D for further information.

2.20 Reporting entity and entity

Throughout this publication, we refer to the entity evaluating another entity for consolidation as the “reporting entity” and the entity subject to consolidation as the “entity.”
**3 Consideration of substantive terms, transactions and arrangements**

**Excerpt from Accounting Standards Codification**

**Consolidation – Overall**

**Scope and Scope Exceptions – Variable Interest Entities**

*810-10-15-13A*

For purposes of applying the Variable Interest Entities Subsections, only substantive terms, transactions, and arrangements, whether contractual or noncontractual, shall be considered. Any term, transaction, or arrangement shall be disregarded when applying the provisions of the Variable Interest Entities Subsections if the term, transaction, or arrangement does not have a substantive effect on any of the following:

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

*810-10-15-13B*

Judgment, based on consideration of all the facts and circumstances, is needed to distinguish substantive terms, transactions, and arrangements from nonsubstantive terms, transactions, and arrangements. The purpose and design of legal entities shall be considered when performing this assessment.

When a reporting entity becomes involved with an entity, only terms, transactions and arrangements that have a substantive effect on the consolidation analysis (e.g., an entity’s status as a VIE, the determination of the primary beneficiary of a VIE) are required to be considered.

The FASB concluded that this guidance is necessary to avoid the form of an entity indicating that an entity is not a VIE or that a reporting entity is not a primary beneficiary when the substance of the arrangement may indicate otherwise. However, the inclusion of this provision is not meant to imply that non-substantive terms should be considered in other areas of accounting. The FASB included this provision in response to concerns regarding the potential for certain reporting entities to engage in restructuring in and around their involvement with a VIE in an effort to maintain their consolidation conclusions that otherwise would have changed upon the adoption of FAS 167.

ASC 810 does not provide detailed implementation guidance or examples of the considerations that reporting entities should evaluate when determining whether terms, transactions and arrangements are substantive. We believe that, in certain circumstances, significant professional judgment is required to determine whether terms, transactions and arrangements are substantive and would therefore be considered in applying the Variable Interest Model.

In considering whether terms, transactions and arrangements are substantive, we believe that it is appropriate to consider, among other things, the purpose and design of the entity and the business rationale for a particular arrangement or transaction. We believe that comparing the terms, transactions and arrangements to the reporting entity’s involvement in other similar entities and to the typical
involvement that other reporting entities may have in similar entities may indicate the substance of an arrangement. For example, if a particular arrangement is consistent with a reporting entity's typical involvement in an entity, it may indicate that the terms, transactions and arrangements are substantive.

After its initial consideration, a reporting entity should evaluate changes in terms, transactions and arrangements that have a substantive effect on the consolidation analysis (see Chapter 11). In evaluating the substance of the changes, we believe it is appropriate to consider, among other things, the entity's purpose and design and the business rationale for the changes. In particular, the business purpose of a change to a transaction or arrangement should be analyzed when alternative arrangements or transactions typically are used with respect to involvement in an entity. For example, changes made to the structure of an arrangement to conform the arrangement to other similar arrangements that the reporting entity is involved in may be relevant in concluding that a change is substantive. Alternatively, changes made to a particular arrangement that deviate from a reporting entity's traditional involvement may call into question the substance of the particular change.

In many circumstances, the underlying economics that accompany a change will be an important consideration. We generally believe that substantive changes to terms, transactions and arrangements will have an economic consequence to the parties involved. For example, assume that party A has a variable interest and would have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance under the Variable Interest Model. Assume that the arrangements between the parties involved with the VIE are altered such that party B is provided with the unilateral ability to remove party A as the party with the power. Thus, under the Variable Interest Model, party A would no longer have power. Also, assume that party A received no substantive compensation as part of party B obtaining the kick-out rights. Under this scenario, the arrangements should be carefully analyzed to determine whether the change is substantive. The fact that party A received no compensation for giving up its rights to control the VIE may raise questions as to whether the changes were substantive.

We believe that it is important for a reporting entity to document the substance of the terms, transactions and arrangements that it enters into.
Scope

4.1 Introduction

Excerpt from Accounting Standards Codification

Consolidation — Overall

Scope and Scope Exceptions — General

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.

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) a VIE, 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.

810-10-15-4

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

Consolidation evaluations always begin with the Variable Interest Model, which was designed to enable a reporting entity to determine whether an entity should be evaluated for consolidation based on variable interests or voting interests. Regardless of what type of entity a reporting entity is evaluating for consolidation, it should first consider the provisions of the Variable Interest Model. If an entity is not a VIE, it would be evaluated for consolidation under the Voting Model under the General subsections of ASC 810-10. See Appendix C for further guidance on the Voting Model and entities controlled by contract.

4.2 Legal entities

The provisions of the Variable Interest Model (and the Voting Model) apply to all legal entities, with limited exceptions. The Codification defines “legal entity” as any legal structure used to conduct activities or to hold assets. Thus, almost any legal structure used to hold assets or conduct activities may be subject to the Variable Interest Model’s provisions. Corporations, partnerships, limited liability companies, other unincorporated entities and trusts are examples of structures that meet this definition. There are no exceptions for structures used by specific industries, and the nature of the structure’s activities or assets held is not considered in determining whether the structure is an “entity” subject to the Variable Interest
The Variable Interest Model's scope is so broad that even a majority-owned (or wholly owned) subsidiary that is legally separate from its parent is subject to the Variable Interest Model and may be a VIE. The parent must determine whether the subsidiary is a VIE. If the subsidiary is not a VIE (or qualifies for one of the Variable Interest Model's scope exceptions), the Voting Model should be followed, and presumably the parent consolidates the subsidiary based on its ownership of a majority of the subsidiary's outstanding voting stock. If, however, the subsidiary is a VIE, the Variable Interest Model must be applied, and the parent should consolidate the subsidiary only if the reporting entity has (1) the power to direct activities of the VIE that most significantly impact 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.

4.2.1 Common arrangements/entities subject to the Variable Interest Model

Entities subject to the Variable Interest Model's provisions include corporations, partnerships, limited liability companies, other unincorporated entities, majority-owned subsidiaries or grantor trusts. Examples of entities/arrangements that may involve VIEs and, accordingly, be subject to the Variable Interest Model's provisions, include but are not limited to:

- Equity-method investees
- Franchises
- Single-purpose insurance and reinsurance entities
- Investment companies:
  - Hedge funds
  - Private equity funds
  - Venture capital funds
  - Mutual funds
Scope

Financial reporting developments

Consolidation and the Variable Interest Model

• Entities used to facilitate leasing arrangements:
  • Build-to-suit arrangements
  • Leases including lessee guarantees of asset values
  • Leases including lessee purchase options
  • Sale-Leasebacks
  • Enhanced Equipment Trust Certificates
  • Sale of property subject to operating leases

• Limited-liability companies:
  • Lot option deposits of homebuilders
  • Land banks used by homebuilders

• Partnerships:
  • Real estate partnerships
  • Investment partnerships

• Entities used to facilitate residential and commercial mortgage-backed securities arrangements

• Entities used to facilitate product and inventory financing arrangements:
  • Vendor financing arrangements
  • Research and development entities

• Entities used to facilitate collaborative arrangements

• Entities receiving assets owned by related parties (including members of management and employees) through a sale or transfer

• Securitization vehicles:
  • Commercial paper conduits
  • Collateralized debt obligations, collateralized bond obligations and collateralized loan obligations

• Entities used for tax-motivated structures:
  • Affordable housing partnerships
  • Synthetic fuel partnerships
  • Wind farms

• Trusts:
  • Trust preferred securities
  • Grantor trusts
  • Credit card master trusts

• Joint ventures
4.2.2 Portions of entities

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Scope and Scope Exceptions — Variable Interest Entities**

**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.

Before the FASB introduced the Variable Interest Model, a multipurpose special-purpose entity (SPE) (e.g., a single SPE with a residual equity investment that owns multiple properties leased to a number of different lessees, each financed with the proceeds from nonrecourse financings that do not contain cross-collateral provisions) was determined to create multiple “virtual” SPEs because the nonrecourse debt with no cross-collateral provisions effectively segregated the cash flows and assets of the various leases. Each virtual SPE was evaluated for potential consolidation by the individual lessees. Applying this approach could have resulted in the recognition of the same asset and nonrecourse debt by both the lessor (because it has legal title to the asset and is the primary obligor of the debt) and the lessee (because a substantive capital investment was not at risk in the virtual SPE during the lease term).

In its deliberations regarding consolidation of VIEs, the FASB decided that the same asset and same debt should not be recognized by multiple parties. Accordingly, the Variable Interest Model provides that a portion of an entity, such as a division, department or branch, is excluded from the Variable Interest Model’s scope unless the entire entity is a VIE. If the entire entity is a VIE, the reporting entity may need to consider whether “silos” are present (see Chapter 6).

**Illustration 4-1: Portions of entities**

**Example 1**
Manufacturer X leases a building under an operating lease from Company Y, which is not a VIE. The lease contains a fixed price purchase option and a first dollar risk of loss residual value guarantee. Company Y finances 100% of its purchase of the asset with nonrecourse debt.

**Example 2**
Company Y creates a separate entity that is a VIE to acquire an asset to be leased to Manufacturer X under the same terms as Example 1. The asset is financed entirely by nonrecourse debt.

**Analysis**
In Example 1, the nonrecourse debt effectively segregates the cash flows and the asset associated with the lease and, therefore, in substance creates a silo in Company Y’s financial statements (see Chapter 6 for guidance on silos). This transaction is economically similar to Example 2, in which the leased asset and the debt are in a separate legal structure. In Example 1, because Company Y is not a VIE, and the Variable Interest Model prohibits a portion of a non-VIE from being treated as a separate entity, Manufacturer X is prohibited from evaluating the assets and liabilities under the lease for potential consolidation under the Variable Interest Model’s provisions. In contrast, in Example 2, the existence of a separate entity invokes the provisions of the Variable Interest Model. Because that entity is a VIE, Manufacturer X is required to determine whether it is the VIE’s primary beneficiary.

Because of the difference in legal form between the two transactions above, different accounting may result when the substance of the transaction is very similar.
4.2.3 Collaborative arrangements not conducted through a separate entity

The Variable Interest Model's provisions apply only to legal structures used to conduct activities and to hold assets. If companies have established a contractual collaborative relationship, but have not formed a separate entity that is used to conduct the joint operations, the Variable Interest Model's provisions do not apply.

**Illustration 4-2: Collaborative arrangements**

Two companies enter into a joint marketing arrangement. Each company agrees to collaboratively produce marketing materials and use their existing sales channels to market the products and services of the other. Each company contractually agrees to share a specified percentage of the revenues received from the sale of products and services made under the joint marketing arrangement to customers of the other company. However, no separate entity is established to conduct the joint marketing activities, and each company retains its own assets and continues to conduct its activities separately from the other.

**Analysis**

Although the companies have contractually agreed to the joint arrangement, because no separate entity has been established to conduct the joint marketing activities, the provisions of the Variable Interest Model should not be applied to the arrangement. Refer to ASC 808 for guidance on accounting for these arrangements.

4.2.4 Majority-owned entities

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Scope and Scope Exceptions — General**

810-10-15-9

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.

All legal entities (as defined) are subject to the Variable Interests Model, including majority-owned and wholly owned entities. Accordingly, a reporting entity should evaluate a majority-owned or wholly owned entity to determine whether (1) the entity qualifies for one of the Variable Interest Model's scope exceptions, (2) the entity is a VIE and (3) if the entity is a VIE, whether the reporting entity is the primary beneficiary.

Applying the Variable Interest Model's provisions could result in a reporting entity not consolidating a wholly-owned or majority-owned subsidiary. For example, if a reporting entity has formed an entity, and the entity's equity is insufficient to absorb its expected losses, the entity would be a VIE. If another variable interest holder in the entity (e.g., a service provider) has (1) the power to direct activities of the VIE that most significantly impact 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, then that variable interest holder would be the primary beneficiary of the VIE (and would consolidate) rather than the reporting entity that holds all or a majority of the equity interests.
In many cases, however, it will be clear that a reporting entity that owns a majority of an entity's voting shares is the entity's primary beneficiary (if, in fact, the entity is a VIE), given its capital structure and corresponding rights with respect to decision-making (i.e., power). As a result, a reporting entity would likely consolidate the majority-owned entity regardless of whether it is an entity evaluated for consolidation based on the ownership of voting interests or variable interests. While it still may be necessary to determine whether the entity is a voting interest entity or a VIE because of the differing disclosure requirements for each type of entity, the Variable Interest Model provides for relief from certain of its disclosures if (1) a reporting entity holds a majority voting interest in a VIE, (2) the VIE meets the definition of a business in ASC 805 and (3) the VIE's assets can be used for purposes other than settling the VIE's obligations (see Chapter 13 for more guidance on disclosures).

4.2.5 Application of Variable Interest Model to tiered structures

We believe the Variable Interest Model should be applied in a “bottoms up” manner in that the lowest-tiered entity should be evaluated as a potential VIE for possible consolidation. In certain circumstances, in making this evaluation, it may be important to understand the relationships in the structure above the entity being evaluated for consolidation (e.g., the relationship between two shareholders of an entity). See Chapter 9 for additional guidance.

Regardless of whether that entity is a VIE or is required to be consolidated by another entity (under either a voting or variable interest model), we believe the lowest-tiered entity’s variable interest holders have variable interests in only that entity; they do not have variable interests in a parent. We believe the parent should, in turn, be evaluated separately as a potential VIE by its own variable interest holders.

Illustration 4-3: Tiered structures

Facts

<table>
<thead>
<tr>
<th>Company A (standalone)</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Co. B</td>
<td>Securities</td>
</tr>
<tr>
<td>Other Assets</td>
<td>Debt</td>
</tr>
<tr>
<td>Equity</td>
<td>Equity</td>
</tr>
<tr>
<td>$ 35</td>
<td>$ 300</td>
</tr>
<tr>
<td>132</td>
<td>150</td>
</tr>
<tr>
<td>$ 167</td>
<td>$ 450</td>
</tr>
</tbody>
</table>

Assume Company B is determined to be a VIE and Company A is its primary beneficiary.

Analysis

We believe Company B first should be evaluated as a potential VIE. This example assumes that Company A is Company B’s primary beneficiary. Accordingly, Company A should consolidate Company B.

In evaluating whether Company A is a VIE, we believe Company A’s standalone balance sheet – without consolidation of Company B – should be used. That is, Company A should be evaluated based on its own contractual arrangements without consideration of Company B’s financial position. In this case, Company A’s variable interest holders are its equity holders. Company B’s variable interest holders remain variable interest holders only in Company B and are not variable interest holders in Company A, even though Company A is required to consolidate Company B.
4.2.6 Fiduciary accounts, assets held in trust

The provisions of the Variable Interest Model apply only to legal entities (as defined). If assets are held on behalf of others (by a trustee, for example), but not in a separate entity, the provisions of the Variable Interest Model would not apply.

4.2.7 Series funds (Updated February 2016)

A “series company” is a type of structure that is common in the asset management industry. It is typically formed as a single corporation or state business trust established under one set of organizational documents and a single board of directors or trustees, but offers investors several funds (series) in which they can invest. These series, commonly referred to as mutual funds, are established within the series company on an as needed basis and are capitalized by issuance of a separate class of common shares to investors. The diagram in Illustration 4-4 depicts a typical series fund.

Illustration 4-4: Series funds

In practice, questions have arisen about whether series funds are “legal entities” under the consolidation guidance.

Excerpt from Accounting StandardsCodification
Consolidation—Overall
Implementation Guidance and Illustrations—Variable Interest Entities

Example of a Series Mutual Fund

810-10-55-8A
An asset management company creates a series fund structure in which there are multiple mutual funds (Fund A, Fund B, and Fund C) within one (umbrella) trust. Each mutual fund, referred to as a series fund, represents a separate structure and legal entity. The asset management company sells shares in each series fund to external shareholders. Each series fund is required to comply with the requirements included in the Investment Company Act of 1940 for registered mutual funds.

810-10-55-8B
The purpose, objective, and strategy of each series fund are established at formation and agreed upon by the shareholders in accordance with the operating agreements. Returns of each series fund are allocated only to that respective fund’s shareholders. There is no cross-collateralization among the individual series funds. Each series fund has its own fund management team, employed by the asset
management company, which has the ability to carry out the investment strategy approved by the fund shareholders and manage the investments of the series fund. The Board of Trustees is established at the (umbrella) trust level.

810-10-55-8E
The shareholders in each series fund have the ability through voting rights to do the following:

a. Remove and replace the Board of Trustees
b. Remove and replace the asset management company
c. Vote on the compensation of the asset management company
d. Vote on changes to the fundamental investment strategy of the fund
e. Approve the sale of substantially all of the assets of the fund
f. Approve a merger and/or reorganization of the fund
g. Approve the liquidation or dissolution of the fund
h. Approve charter and bylaw amendments
i. Increase the authorized number of shares.

An example in ASC 810-10-55-8A through 8H provides an example of a series fund structure (i.e., multiple series or mutual funds within one umbrella entity), whereby each individual fund is required to comply with the 1940 Act. In this example the series fund is considered an entity as defined based on its characteristics and should be evaluated separately for consolidation. The 1940 Act requires that each fund:

- Have its own investment objectives and policies
- Have its own custodial agreement
- Have its own shareholders separate from other series funds
- Have a unique tax identification
- File separate tax returns with the Internal Revenue Service
- Have separate audited financial statements
- Be considered by the Securities and Exchange Commission (SEC) staff to be a separate investment company in virtually all circumstances for investor protection afforded by the 1940 Act

As stated in paragraph 39 of the Basis for Conclusions to ASU 2015-02,

“On the basis of these considerations, the Board acknowledged that it is reasonable to treat individual series funds as separate legal entities in accordance with the Master Glossary, which indicates that a legal entity is ‘any legal structure used to conduct activities or to hold assets.’”

The example in ASC 810-10-55-8A through 8H also illustrates the determination of how to evaluate whether a series fund is a VIE (see Section 7.3.1.3.1 for additional guidance).

If the series fund is considered a separate legal entity, it would be a voting interest entity because the series fund’s equity holders would have the ability to make the decisions that most significantly impact the series fund’s economic performance (assuming none of the other two VIE criteria are met).
Question 4.1  Will a series fund that is not required to comply with the 1940 Act meet the definition of a legal entity?

It depends on the facts and circumstances. We believe that this analysis will require careful consideration of the facts and circumstances and should consider the criteria in paragraph BC 38 of the Basic for Conclusions to ASU 2015-02 (as listed above) to the extent those criteria are relevant or applicable to the fact pattern.

We understand that the SEC staff believes the determination of whether a series fund meets the definition of a legal entity should focus on determining whether: (1) the assets, liabilities and equity of the series fund are legally isolated (2) the series fund’s equity holders have the rights to direct the activities of the series fund’s that most significantly impact its economic performance. We believe that such rights generally include the ability to remove and replace the series fund’s manager or liquidate the series fund, approve the compensation of the series fund’s manager and vote on changes to the fundamental investment strategy of the series fund.

Question 4.2  Can the FASB’s conclusion with respect to a series fund be applied by analogy to other structures?

ASC 810 does not provide guidance as to whether applying the conclusion for series funds to other structures by analogy is appropriate. In certain circumstances, a reporting entity must apply professional judgment, based on facts and circumstances, to determine whether the structure being evaluated has the necessary attributes that indicate it is analogous to a series fund. Based upon the example in ASC 810, we believe that the characteristics of a series fund are unique. As such, we believe that it may be uncommon for other structures to have all of the relevant attributes that are similar to those of a 1940 Act series fund. We believe that the concepts of legal isolation and decision making explained in Question 4.1 should also be applied when determining if the FASB’s conclusion with respect to a series fund could be applied to other structures.

4.3  Scope exceptions to consolidation guidance

Excerpt from Accounting Standards Codification

Consolidation — Overall

Scope and Scope Exceptions — General

810-10-15-12

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

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

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

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

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

e.  A reporting entity shall not consolidate a governmental organization and shall not consolidate a financing entity established by a governmental organization unless the financing entity meets both of the following conditions:

   1.  Is not a governmental organization.

   2.  Is used by the business entity in a manner similar to a (VIE) in an effort to circumvent the
provisions of the Variable Interest Entities Subsections.

f. A reporting entity shall not consolidate a legal entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

1. A legal entity that is not required to comply with Rule 2a-7 of the Investment Company Act of 1940 qualifies for this exception if it is similar in its purpose and design, including the risks that the legal entity was designed to create and pass through to its investors, as compared with a legal entity required to comply with Rule 2a-7.

2. A reporting entity subject to this scope exception shall disclose any explicit arrangements to provide financial support to legal entities that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7, as well as any instances of such support provided for the periods presented in the performance statement. For purposes of applying this disclosure requirement, the types of support that should be considered include, but are not limited to, any of the following:

   i. Capital contributions (except pari passu investments)

   ii. Standby letters of credit

   iii. Guarantees of principal and interest on debt investments held by the legal entity

   iv. Agreements to purchase financial assets for amounts greater than fair value (for instance, at amortized cost or par value when the financial assets experience significant credit deterioration)

   v. Waivers of fees, including management fees.

There are four scope exceptions to the consolidation guidance in ASC 810: (1) employee benefit plans, (2) certain investment companies (3) governmental organizations and (4) money market funds required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the 1940 Act. We believe that the FASB intended for the exceptions to be applied literally and that it is inappropriate to analogize to the scope exceptions. That is, unless a specific scope exception exists, a legal entity (as defined by ASC 810-10) is subject to all of the provisions of the consolidation guidance.

There are five other scope exceptions specific to the Variable Interest Model (see Section 4.4).

### 4.3.1 Employee benefit plans

An employer should not consolidate its sponsored employee benefit plans that are subject to the provisions of ASC 712 or 715. However, other parties with variable interests in employee benefit plans (e.g., trustees, administrators) should evaluate these entities as potential VIEs or voting interest entities for consolidation.

#### 4.3.1.1 Employee benefit plans not subject to ASC 712 or 715

While employee benefit arrangements not subject to ASC 712 or 715 must consider the Variable Interest Model or Voting Model, we believe a trust that holds assets to cover benefits under a health and welfare benefit plan (e.g., a voluntary employees’ benefit association or a 501(c)(9) trust) is not to be consolidated by an employer. The employer’s accounting for health and welfare benefit plans is not in the scope of ASC 712 or 715. However, the AICPA Accounting and Auditing Guide, *Audits of Employee Benefit Plans*, uses certain of those standards’ measurement concepts. While we generally believe that analogies to scope exceptions to consolidation guidance are not appropriate, we do not believe the FASB intended to
include a trust holding assets under a health and welfare benefit plan in the scope of the Variable Interest Model or Voting Model. We understand the FASB staff shares our view.

### 4.3.1.2 Employee stock ownership plans

An employee stock ownership plan (ESOP) is a compensation/benefit vehicle used to transfer a company’s (the sponsor’s) shares to its employees on a tax-deferred basis. An ESOP is a special type of a tax-qualified defined contribution retirement plan. ESOPs can be established to compensate employees, provide the means for a sponsor to match contributions to a 401(k) plan or even as an exit vehicle for a retiring founder. ESOP structures also vary in the type of stock held (i.e., either the sponsor’s common shares or its convertible preferred stock).

ESOPs can be leveraged or non-leveraged. In a non-leveraged ESOP, the ESOP receives shares from the sponsor, usually annually, which are immediately allocated to specific employee accounts. Those shares remain in the ESOP until they are distributed to the employees, generally at termination or retirement. Vesting requirements often exist, which provide that if the employee terminates his employment with the company prior to a specified date, the underlying shares are redistributed to the other participants or applied to reduce the sponsor’s next contribution. The shares may not be returned to the sponsor.

A leveraged ESOP issues debt and uses the proceeds to buy shares either from the sponsor or in the market. All the shares are initially unallocated (or are in suspense) but become released to specific employee accounts as the ESOP makes its debt-service payments. Vesting provisions often apply. As a result, a leveraged ESOP typically has three types of shares at any point in time: unallocated shares in the suspense account, allocated but unvested shares and vested shares.

A leveraged ESOP can either borrow externally (e.g., from a bank or other lender) or internally from the sponsor. In either case, the ESOP has no source of funds for debt service other than dividends (if any) on the shares held. Therefore, it must rely on the sponsor’s subsequent contributions to provide the necessary funding.

The consolidation guidance provides a scope exception to an employer for its employee benefit plans subject to the provisions of ASC 712 or 715.

Non-leveraged ESOPs are defined contribution pension plans covered by ASC 718. ASC 718 includes guidance on non-leveraged ESOPs that is generally consistent with the guidance for defined contribution plans in ASC 715. Accordingly, we believe that non-leveraged ESOPs are excluded from the scope of consolidation guidance for their sponsors.

The guidance for accounting for leveraged ESOPs in ASC 718 is not consistent with the guidance for defined contribution plans in ASC 715 (because vesting is not a factor in recognizing compensation costs for defined contribution plans under ASC 715, and ASC 718 provides accounting models for when shares are to be credited to unearned ESOP shares and the measurement of compensation). However, because leveraged ESOPs are a form of defined contribution plan and ASC 718 provides detailed clarifying guidance for leveraged ESOPs, we believe an employer, likewise, should not evaluate a leveraged ESOP for potential consolidation pursuant to the Variable Interest Model or Voting Model.

### 4.3.1.3 Deferred compensation trusts (e.g., a rabbi trust)

We generally believe a rabbi trust will be a VIE. A rabbi trust that is not a VIE should be consolidated pursuant to ASC 710-10-45-1. If it is determined that a rabbi trust should not be consolidated, a reporting entity should evaluate whether financial assets that are transferred to a rabbi trust should be derecognized in accordance with the provisions of ASC 860.

Certain deferred compensation arrangements allow amounts earned by employees to be invested in the stock of the employer or other assets and placed in a rabbi trust. A rabbi trust is a funding vehicle sometimes used to protect promised deferred executive compensation benefits from events other than bankruptcy.
A rabbi trust protects the funded benefits against hostile takeover ramifications and disagreements with management but not against the claims of general creditors if bankruptcy occurs. This important protection is provided while deferring income taxes for the employees.

We generally believe a rabbi trust will be a VIE because the rabbi trust has no equity (it has a liability to the employees). When a rabbi trust is determined to have equity, that rabbi trust also will be a VIE because the equity investment is not at risk pursuant to ASC 810-10-15-14(a)(3), as the employer provided the equity investment to the employee. As discussed in Section 7.2.2.3, equity interests provided in exchange for services generally are not considered to be at risk.

Because a rabbi trust generally will be a VIE, a reporting entity (the employer) must consider whether it has (1) the power to direct activities of a rabbi trust that most significantly impact its economic performance and (2) the obligation to absorb losses or the right to receive benefits from a rabbi trust that could potentially be significant to the rabbi trust.

In most circumstances, we believe that the employer will be the primary beneficiary. The decisions that most significantly impact the economic performance of a rabbi trust will be those involving the funding of the trust and the investment strategy. While the employee may indicate a desired strategy, we generally believe that the investment decisions of a rabbi trust rest with the employer. In addition, decisions involving funding of the trust rest with the employer. As a result, the employer has the power to make decisions that most significantly impact the economic performance of the rabbi trust. In addition, the employer has benefits that could be potentially significant to the economic performance of the trust by virtue of its contingent call option on the rabbi trust's assets in the event of the employer's bankruptcy.

Because plans and trust agreements vary, careful consideration of the specific terms and conditions is required before applying the Variable Interest Model.

4.3.1.4 Applicability of the Variable Interest Model to the financial statements of employee benefit plans

The financial statements of defined benefit plans generally are prepared pursuant to ASC 960. The financial statements of defined contribution plans and other employee health and welfare benefit plans generally are prepared pursuant to the AICPA Audit and Accounting Guide, Audits of Employee Benefit Plans.

Historically, employee benefit plans generally have not applied consolidation guidance. Historical consolidation guidance has specified that it was “directed primarily to business reporting entities organized for profit.”

We understand from discussions with the FASB staff that the FASB didn't intend to broaden the applicability of the consolidation guidance in ASC 810 through the establishment of the Variable Interest Model such that it would apply to the financial statements of employee benefit plans. Accordingly, we do not believe that an employee benefit plan should apply the Variable Interest Model.

4.3.1.5 Service providers to employee benefit plans

Only sponsoring employers are exempt from applying the consolidation guidance to their employee benefit plans that are subject to the provisions of ASC 712 or 715. Other parties with variable interests in employee benefit plans, such as investment advisers and plan administrators, should evaluate their interests because the scope exception does not apply to other variable interest holders in the plan.

4.3.2 Investment companies

ASC 946 provides guidance on determining whether an entity is an investment company. Investments in non-investment companies made by an investment company are accounted for under ASC 946 and are not subject to the consolidation or the disclosure requirements of ASC 810. See Appendix F for additional guidance on the definition of an investment company and consolidation considerations.
4.3.3 Governmental entities

The consolidation guidance provides that a reporting entity should not consolidate a governmental organization (e.g., a state or local governmental agency, airport authority). However, certain entities formed by governmental entities (e.g., municipal bond trusts formed by economic development authorities) may be potential VIEs that are subject to consolidation.

Governmental entities following accounting standards issued by the Governmental Accounting Standards Board (GASB) are not required to apply the provisions of ASC 810, unless they have elected to apply standards issued by the FASB under GASB 20.

4.3.3.1 Governmental financing entities

The consolidation guidance provides that a financing entity formed by a governmental organization should not be consolidated by a reporting entity, unless the financing entity:

(1) is not a governmental organization and
(2) is used by the reporting entity in a manner similar to a VIE in an effort to circumvent its provisions.

The AICPA Audit and Accounting Guide, Audits of State and Local Governments (GASB 34 Edition), defines a governmental entity as having 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 government with the net assets reverting to a 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 characteristics may rebut the presumption that they are governmental entities if their determination is supported by compelling evidence.

A governmental agency may form a separate entity (such as a municipal bond trust) for the specific purpose of allowing a reporting entity to obtain lower-cost financing (generally due to tax benefits provided to investors) as an incentive to have the reporting entity invest in an economically distressed area or to serve some specific public purpose. Although governmental entities are not subject to consolidation, we believe that a separate financing entity formed by a governmental agency to assist a reporting entity in obtaining lower-cost financing will not necessarily be a governmental entity, based on the characteristics above. That is, it may meet the first condition above.

However, in order to be subject to the Variable Interest Model, a financing entity formed by a governmental entity also must be used by the reporting entity in a manner similar to a VIE in an effort to circumvent the application of the Variable Interest Model. We believe the SEC staff is applying this scope exception somewhat literally. Accordingly, we believe that it would be difficult to justify how a financing entity that issues debt that pays interest exempt from federal taxation could be used to circumvent consolidation provisions. That is, we believe that it would be difficult to assert that a financing vehicle that met the criteria to issue tax-exempt debt was used to circumvent consolidation without calling into question whether the financing entity should continue to have the ability to issue debt with preferential tax treatment. Accordingly, while all of the relevant facts and circumstances should be considered to evaluate whether this scope exception applies, we believe a financing entity that issues debt that pays interest exempt from federal taxation generally will not be subject to the Variable Interest Model’s provisions, because the second condition above is not met.
4.3.4 Money market funds

ASU 2015-02 eliminates the deferral of FAS 167 and permanently exempts a reporting entity from consolidating money market funds that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the 1940 Act.

To determine whether a fund operates in accordance with requirements that are “similar” to Rule 2a-7, the reporting entity would consider the purpose and design of the fund, including its portfolio quality, maturity and diversification.

As noted in paragraph 82 of the Basis for Conclusions to ASU 2015-02:

“The Board concluded that the characteristics required for consideration when conducting the “similar” evaluation are the purpose and design of the fund as well as the risks that the fund was designed to create and pass through to its interest holders. When considering the purpose and design and the risks of the fund, the Board expected that a “similar” fund would seek to maintain the principal investment by minimizing the fund’s exposure to credit risk and allowing for investor redemptions from the fund on a daily basis. When considering the risks that the fund was designed to create and pass through to its interest holders, the Board expects entities to assess whether the fund’s portfolio quality, maturity, and diversification are similar to a money market fund that complies with or operates in accordance with Rule 2a-7, with a focus on the following:

a. Portfolio quality: Invest in high-quality, short-term securities that are judged to present credit risk similar to investments held by a money market fund that complies with or operates in accordance with Rule 2a-7.

b. Portfolio maturity and diversification: Follow an overall objective regarding the credit quality and maximum maturity of eligible investments, the diversification of the fund’s portfolio, and its overall average maturity that is consistent with a money market fund that complies with or operates in accordance with Rule 2a-7.”

Some facts to consider in this determination may include, but are not limited to the following:

- Limits on the maturities of investments (e.g., short-term securities)
- Minimum required liquidity of the fund’s investments
- Requirements governing the credit quality of the fund’s investments
- Requirements related to the fund’s concentration of risk or diversification of the fund’s portfolio
- The nature of the regulation under which a foreign fund operates

A reporting entity that has an interest in a money market fund that is permanently exempt from being consolidated is required to disclose any financial support it provided to the fund during the periods presented in the financial statements and any explicit arrangements to provide financial support in the future. Financial support could include capital contributions, standby letters of credit, guarantees of principal and interest, agreements to purchase troubled securities and waivers of fees, including management fees.

The FASB decided that issuing a scope exception for interests in money market funds was the most effective way to address constituents’ concerns that consolidating these funds would not provide decision-useful information.
The criteria money market funds must meet to qualify for the scope exception under ASC 810-10-15-12(f) are consistent with the criteria the funds had to meet previously to qualify for the deferral of FAS 167. Therefore, we believe that those money market funds that were eligible for the deferral should qualify for the scope exception.

In July 2014, the SEC issued final rules that will affect funds required to comply with Rule 2a-7 of the 1940 Act. Once effective, these rules may impose restrictions on redemptions. If an unregistered money market fund doesn't impose redemption restrictions, would that fact preclude the fund from being considered similar to a registered money market fund that is required to comply with Rule 2a-7?

As background, in July 2014, the SEC issued final rules aimed at minimizing money market funds' exposure to rapid redemptions. Institutional prime money market funds will be required to operate with a floating net asset value (NAV). Boards of directors of nongovernment money market funds will be required to impose a 1% fee on redemptions if the fund's weekly liquid assets fall below 10% of total assets unless the board determines that imposing such a fee would not be in the best interest of the fund. Boards of these funds will have the option of imposing redemption fees of up to 2% and/or suspending redemptions (i.e., imposing gates) for up to 10 business days in a 90-day period, if the fund’s weekly liquid assets fall below 30% of its total assets. Government funds will be permitted but not required to impose fees and gates. The rules have a two-year transition period and become effective in 2016.

Generally, we would not expect the conclusion of whether a fund operates in accordance with requirements that are “similar” to Rule 2a-7 to change solely as a result of the SEC’s rules for money market funds becoming effective in 2016. While we believe that the scope exceptions to the consolidation guidance should be evaluated continuously, we do not believe that the specific changes that were introduced by the SEC in 2014 that are described above would cause a fund that was previously eligible to no longer qualify for the money market fund scope exception.

### 4.4 Scope exceptions to the Variable Interest Model

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidation – Overall</td>
</tr>
<tr>
<td><em>Scope and Scope Exceptions – Variable Interest Entities</em></td>
</tr>
<tr>
<td>810-10-15-13</td>
</tr>
<tr>
<td>The Variable Interest Entities Subsections follow the same Scope and Scope Exceptions as outlined in the General Subsection of this Subtopic (see paragraph 810-10-15-1), with specific transaction qualifications and exceptions noted below.</td>
</tr>
<tr>
<td>810-10-15-17</td>
</tr>
<tr>
<td>The following exceptions to the Variable Interest Entities Subsections apply to all legal entities in addition to the exceptions listed in paragraph 810-10-15-12:</td>
</tr>
<tr>
<td>a. Not-for-profit entities (NFPs) are not subject to the Variable Interest Entities Subsections, except that they may be related parties for purposes of applying paragraphs 810-10-25-42 through 25-44. In addition, if an NFP is used by business reporting entities in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entities Subsections, that NFP shall be subject to the guidance in the Variable Interest Entities Subsections.</td>
</tr>
<tr>
<td>b. Separate accounts of life insurance entities as described in Topic 944 are not subject to consolidation according to the requirements of the Variable Interest Entities Subsections.</td>
</tr>
</tbody>
</table>
c. A reporting entity with an interest in a VIE or potential VIE created before December 31, 2003, is not required to apply the guidance in the Variable Interest Entities Subsections to that VIE or legal entity if the reporting entity, after making an exhaustive effort, is unable to obtain the information necessary to do any one of the following:

1. Determine whether the legal entity is a VIE
2. Determine whether the reporting entity is the VIE’s primary beneficiary
3. Perform the accounting required to consolidate the VIE for which it is determined to be the primary beneficiary.

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

d. A legal entity that is deemed to be a business need not be evaluated by a reporting entity to determine if the legal entity is a VIE under the requirements of the Variable Interest Entities Subsections unless any of the following conditions exist (however, for legal entities that are excluded by this provision, other generally accepted accounting principles [GAAP] should be applied):

1. The reporting entity, its related parties (all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d)), or both participated significantly in the design or redesign of the legal entity. However, this condition does not apply if the legal entity is an operating joint venture under joint control of the reporting entity and one or more independent parties or a franchisee.
2. The legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties.
3. The reporting entity and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity based on an analysis of the fair values of the interests in the legal entity.
4. The activities of the legal entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.

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

**Accounting Alternative**

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.

810-10-15-17B
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.

810-10-15-17C
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.

There are five other scope exceptions specific to the Variable Interest Model: (1) not-for-profit organizations, (2) separate accounts of life insurance companies, (3) lack of information (4) certain entities deemed to be businesses and (5) a private company accounting alternative. We believe that it is inappropriate to analogize to the scope exceptions. That is, unless a specific scope exception applies, a legal entity (as defined by ASC 810-10) is subject to all of the provisions of the Variable Interest Model. If a reporting entity qualifies for one of the scope exceptions to the Variable Interest Model, it should consider the voting interest entity provisions of ASC 810 to determine whether consolidation is required. If a reporting entity does not qualify for one of the scope exceptions to the Variable Interest Model, it is within the scope of the Variable Interest Model and must further evaluate the entity for possible consolidation under that model.

4.4.1 Not-for-profit organizations
A not-for-profit organization does not evaluate an entity for consolidation under the Variable Interest Model. Instead, not-for-profit organizations apply the guidance in ASC 958-810 to determine whether it has a controlling financial interest in an entity. Additionally, a for-profit reporting entity does not evaluate a not-for-profit organization for consolidation under the Variable Interest Model, but should consider the other consolidation guidance in ASC 810. These evaluations are summarized in the following table:

<table>
<thead>
<tr>
<th>Reporting entity</th>
<th>Entity being evaluated for consolidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not-for-profit</td>
<td>Apply ASC 958-810</td>
</tr>
<tr>
<td>For profit entity</td>
<td>Apply other sections of ASC 810 (excluding the Variable Interest Model)</td>
</tr>
</tbody>
</table>
When the Variable Interest Model was introduced, the FASB provided a scope exception for not-for-profit organizations evaluating entities for consolidation because traditional consolidation literature referred only to “business reporting entities.” The FASB did not believe it was appropriate to extend the Variable Interest Model to not-for-profit organizations evaluating entities for consolidation because the consolidation literature did not specifically apply to such organizations. The FASB acknowledged, however, that some of the requirements in ASC 810-10 (outside of the Variable Interest Model) are applied by certain not-for-profit organizations and did not intend for the Variable Interest Model to result in a change in those practices.

In December 2015, the FASB tentatively decided to add a project to its agenda to clarify when a not-for-profit entity that is a general partner should consolidate a for-profit limited partnership. We encourage readers to monitor developments in this area.

**Question 4.4**

**How should a for-profit entity evaluate whether to consolidate a not-for-profit organization?**

As long as a reporting entity is not using a not-for-profit organization to circumvent the Variable Interest Model, the not-for-profit organization is excluded from the scope of the Variable Interest Model. Therefore, a for-profit entity would consider whether to consolidate a not-for-profit organization under the Voting Model (i.e., General subsections of ASC 810-10). The guidance under the Entities Controlled by Contract subsections of ASC 810-10 could also apply.

Under the Voting Model, a for-profit reporting entity that has a variable interest in a not-for-profit organization and serves as the sole corporate member or controls the board of directors generally would consolidate a not-for-profit organization absent the presence of substantive kick-out rights or participating rights held by a third party or parties.

As described in ASC 810-10-15-8, “For legal entities other than 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.” Therefore, being the sole corporate member in a not-for-profit organization, like ownership of a majority voting interest in a for-profit entity, generally is considered a controlling financial interest.

**4.4.1.1 Not-for-profit organizations used to circumvent consolidation**

If, based on the individual facts and circumstances, a reporting entity is using a not-for-profit organization to circumvent the Variable Interest Model, the not-for-profit organization that would otherwise be excluded from the scope should be evaluated under the Variable Interest Model.

**Illustration 4-5: Not-for-profit organization used to circumvent consolidation**

Assume Company A leases a building from a VIE (lessor) and concludes that, by applying the Variable Interest Model, it is the VIE's primary beneficiary and, as such, would be required to consolidate the VIE. As a result, Company A restructures the lease so Company A's charitable foundation becomes the lessee and Company A enters into a sublease with the foundation that is an operating lease under ASC 840.

**Analysis**

Because the charitable foundation is being used by Company A to avoid consolidating the VIE (lessor), the charitable foundation is subject to the Variable Interest Model (and Company A would look through the foundation and consolidate the VIE).
We understand, generally, that the SEC staff applies the not-for-profit scope exception somewhat literally. For example, certain reporting entities may contract with state or local governmental agencies to provide certain services in a defined geographical area. The governmental agencies may be statutorily prohibited from contracting for such services with for-profit organizations. To conduct its business operations, the reporting entity may form a not-for-profit organization to contract directly with the governmental agencies. The not-for-profit organization has no other activities, and employees of the reporting entity comprise the majority of the not-for-profit organization’s board membership. Concurrently, the reporting entity enters into a management agreement with the not-for-profit organization to effectively outsource the provision of the services from the not-for-profit organization to the reporting entity. The fees charged to the not-for-profit organization by the reporting entity approximate the fees charged to the governmental agency by the not-for-profit organization. The outsourcing contract is structured in such a way that the not-for-profit organization continues to qualify as such under the Internal Revenue Code. We understand the SEC staff would weigh heavily the fact that, because the not-for-profit organization was not formed in an attempt to circumvent the provisions of the Variable Interest Model, the scope exception applies, even though the not-for-profit organization exists solely to allow the reporting entity to conduct its for-profit business activities.

### 4.4.1.2 Not-for-profit organizations as related parties

If a not-for-profit organization holding a variable interest in a VIE is a related party to a reporting entity that also holds a variable interest in the same VIE, the interests of the not-for-profit organization should be aggregated with that of the reporting entity if considering the related party provisions of the Variable Interest Model is necessary (i.e., no party with a variable interest in the VIE individually has power). A not-for-profit organization could be a reporting entity’s related party if, for example, the reporting entity contributed the variable interest to the not-for-profit organization. See Chapters 9 and 10 regarding the Variable Interest Model’s related party provisions.

### 4.4.2 Separate accounts of life insurance reporting entities

Separate accounts of life insurance reporting entities, as described in ASC 944, are not subject to the Variable Interest Model’s consolidation provisions. Certain provisions within ASC 944 specifically require life insurance reporting entities to recognize assets and liabilities held in separate accounts. The FASB chose not to change those requirements without a broader reconsideration of accounting by insurance reporting entities, which was beyond the scope of the Variable Interest Model project.

See Section 10.2.3 for guidance on how an insurance reporting entity should consider investments held by a separate account in the insurance reporting entity’s consolidation analysis of the underlying investee.

### 4.4.3 Information availability

Some entities that are potential VIEs created before 31 December 2003 may not have included provisions in their organizational and other documents assuring that all parties involved would have access to information required to apply the Variable Interest Model. Therefore, a reporting entity with an interest in an older entity may be unable to obtain information to (1) determine whether the entity is a VIE, (2) determine whether the reporting entity is the primary beneficiary of the VIE or (3) consolidate the VIE for which it is determined to be the primary beneficiary.

Consequently, a reporting entity is not required to apply the provisions of the Variable Interest Model to entities created before 31 December 2003, if the reporting entity is unable to obtain information necessary to (1) determine whether the entity is a VIE, (2) determine whether the reporting entity is the VIE’s primary beneficiary or (3) perform the accounting required to consolidate the VIE. To qualify for this scope exception, the reporting entity must have made and must continue to make exhaustive efforts to obtain the information. The scope exception applies to individual VIEs or potential VIEs, not to a class of entities if information is available for some members of the class.
The FASB believes situations to which this scope exception will apply will be infrequent, particularly when the reporting entity was involved in creating the entity. A reporting entity holding a variable interest in another entity that exposes it to substantial risks would normally obtain information about that entity to monitor its exposure (even if the exposure is limited). Additionally, the exception will apply only until the necessary information is obtained. At that point, the provisions of the Variable Interest Model will apply. Reporting entities using this scope exception have a continuing obligation to attempt to obtain the necessary information.

We believe that it is inappropriate for a reporting entity to apply this scope exception if a significant amount of information about an entity is known by the reporting entity and reasonable assumptions can be made about the unknown information necessary to apply the provisions. If material, disclosures should be made about the assumptions used.

If this scope exception has been applied and the information subsequently becomes available, the Variable Interest Model must be applied at that time. If the reporting entity determines that the entity is a VIE and it must consolidate the entity as its primary beneficiary, it should initially consolidate the entity through a cumulative catch-up adjustment (similar to the methodology used for adopting ASU 2015-02).

As discussed in a December 2003 speech, the SEC staff believes that when making a determination of when an entity was created, consideration should be given to whether the entity was created and began substantive operations before 31 December 2003. The SEC staff believes that the exception should not be applied to an entity whose legal structure was formed prior to that date but who began substantive operations or was reconfigured after 31 December 2003 in such a way that the “creation date” of the entity is not relevant. Also, the scope exception should not be applied to entities that were created before 31 December 2003 and had substantive operations before 31 December 2003, if the entity became dormant and was “reactivated” after 31 December 2003.

ASC 810-10 does not provide guidance on what constitutes “exhaustive” efforts. Determining when a reporting entity makes exhaustive efforts without successfully obtaining the required information will be based on the applicable facts and circumstances. Companies wishing to use this scope exception should be prepared to document the efforts they have made to obtain the necessary information. We understand that in determining whether an entity has inappropriately applied this scope exception, the SEC staff intends to consider all relevant facts and circumstances, including whether registrants operating in the same industry with similar types of arrangements were able to obtain the required information. The SEC staff will address whether this scope exception has been inappropriately applied on a case-by-case basis, as discussed in the December 2003 speech.

The SEC staff also expanded on its views about the use of this scope exception in a December 2004 speech. The SEC staff noted that in those cases where a company believes it can use the information availability scope exception for entities created before 31 December 2003, the company should be prepared to support how it has satisfied the exhaustive efforts criterion.

---

5 See speech made by Eric Schuppenhauer at the 2003 AICPA National Conference on Current SEC and PCAOB Developments available at www.sec.gov. We believe that references to FIN 46(R) in the speech also would apply to the current Variable Interest Model.

6 See speech made by Jane D. Poulin at the 2004 AICPA National Conference on Current SEC and PCAOB Developments available at www.sec.gov. We believe that references to FIN 46(R) in the speech also would apply to the current Variable Interest Model.
4.4.4 Business scope exception

The business scope exception lists conditions that, if met, would obviate the need for further analysis and application of the Variable Interest Model.

A reporting entity is not required to apply the provisions of the Variable Interest Model to an entity that is deemed to be a “business” (as defined by ASC 805) unless any of the following conditions exist:

- The reporting entity, its related parties or both participated significantly in the design or redesign of the entity, suggesting that the reporting entity may have had the opportunity and the incentive to establish arrangements that result in it being the variable interest holder with power. Joint ventures and franchisees are exempt from this condition. That is, assuming the other conditions below do not exist, a reporting entity that participated significantly in the design or redesign of a joint venture or franchisee is not required to apply the provisions of the Variable Interest Model.

- The 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.

- The reporting entity and its related parties provide more than half of the total equity, subordinated debt and other forms of subordinated financial support to the entity based on an analysis of fair values of the interests in the entity.

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

When evaluating the Variable Interest Model, the term “related parties” includes parties identified in ASC 850 and certain other related parties that are acting as de facto agents of the variable interest holder unless otherwise specified (see Chapter 10).

ASC 810-10-15-17(d) implies that the evaluation of an entity meeting the requirements of the business scope exception should be performed on an ongoing basis. Accordingly, we believe that an entity not previously evaluated to determine whether it was a VIE because it used the business scope exception must be evaluated in future periods to determine whether the entity continues to be eligible.

It is important to carefully consider all of the criteria listed above when evaluating whether an entity is eligible for the business scope exception. In practice, some incorrectly assume that an entity qualifies for the business scope exception because the entity being evaluated for consolidation meets the definition of a business but fail to consider the other conditions described above. The criteria for the business scope exception were intended to limit the circumstances in which the exception would apply. Because of the rigid criteria established for the business scope exception, most entities will not be eligible for the exception.

4.4.4.1 Definition of a business (Updated February 2016)

ASC 805 provides guidance for determining what constitutes a business when applying the scope exception. ASC 805 defines a business as “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.”

Under ASC 805, the determination of whether an integrated set of activities and assets is a business is based on whether the integrated set of activities and acquired assets “is capable of being conducted and managed for the purpose of providing a return.” Thus, under ASC 805 an acquired set of assets does not need to include all of the inputs or processes that the seller used in operating that set of assets to constitute a business.
If a market participant, as defined in ASC 805, is capable of using the acquired set of assets to produce outputs, for example, by integrating the set of assets with its own inputs and processes, the acquired set of assets might constitute a business. In other words, in evaluating whether a particular set of assets and activities is a business, it is not relevant whether the seller had historically operated the transferred set as a business or whether the acquirer intends to operate the transferred set as a business. The term “capable of” is sufficiently broad and requires significant judgment to assess whether an acquired set of activities and assets constitutes a business. See our FRD, Business combinations, for further discussion of the definition of a business.

In November 2015, the FASB proposed guidance that would change the definition of a business. In doing so, the FASB is responding to concerns raised by constituents that the current definition of a business is too broad and can be challenging to apply in practice. The FASB proposed guidance that would (1) require that if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business, (2) require that a business include at least one substantive process and (3) narrow the definition of outputs. We encourage readers to monitor developments in this area.

**4.4.2 Significant participation in the design or redesign of an entity**

If a reporting entity, its related parties or both participated significantly in the design or redesign of an entity (that is not a joint venture or franchisee), the reporting entity is prevented from utilizing the business scope exception to the Variable Interest Model. We believe a reporting entity holding a variable interest in an entity generally should be deemed to have significantly participated in the design or redesign of the entity, if any of the following criteria are met:

- The entity was initially formed as a wholly or majority-owned subsidiary of the reporting entity or its related parties (including de facto agents, except those described in paragraph 810-10-25-43(d) of the Variable Interest Model – see Chapter 10).
- The reporting entity or its related parties (including de facto agents, except those described in paragraph 810-10-25-43(d) of the Variable Interest Model – see Chapter 10) held a significant variable interest in the entity at or shortly after the entity’s formation or redesign.
- The entity was formed or restructured by others on behalf of the reporting entity or its related parties (including de facto agents, except those described in paragraph 810-10-25-43(d) of the Variable Interest Model – see Chapter 10). If the reporting entity or its related parties acquire a significant variable interest in an entity shortly after formation, this may indicate that the entity was formed on its behalf. Determining whether the entity was formed on behalf of the reporting entity will be based on the facts and circumstances and will require the use of professional judgment.

We believe that the “design or redesign of the entity” refers to the legal structure, including ownership of variable interests in the entity, nature of the variable interests and nature of the entity’s activities. If an entity’s operations are significantly revised, this should be considered a redesign of the entity, even if the ownership of variable interests or the legal structure of the entity is not substantially changed.

The determination of whether a variable interest holder participated significantly in the design or redesign of an entity should be based on consideration of all relevant facts and circumstances.

**4.4.2.1 Determining whether an entity is a joint venture**

Assuming the other conditions of the business scope exception do not exist, a reporting entity that participated significantly in the design or redesign of a joint venture that is a business (as defined by ASC 805) is not required to apply the provisions of the Variable Interest Model.
A party to a transaction may believe an entity is a joint venture when, in fact, it is not. Some reporting entities use the term “joint venture” loosely to describe involvement with another entity. However, for accounting purposes, the term is narrowly defined in ASC 323-10-20. The fundamental criteria for an entity to be a joint venture are (1) joint control over all key decisions, with (2) control through the owners’ equity interest. For example, if three parties form a venture and make decisions about the venture based on a majority vote, the entity is not a joint venture for accounting purposes because decisions are not made jointly (with consent among all parties). Also, even if an entity meets the definition of a joint venture, it is still subject to the remaining three criteria of the business scope exception.

ASC 323-10-20 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.”

Entities described as joint ventures are organized in a variety of legal forms. In addition to the corporate form, partnerships and individual interests may also be used to organize a joint venture as contemplated by ASC 323-30-15-3.

We believe that to conclude an entity is a joint venture under joint control, the following conditions generally should be present:

- The entity should be under the joint control of the venturers.
- The venturers must be able to exercise control of the venture through their equity investments.

Joint control of major decisions is one of the most significant characteristics of the class of entities described as joint ventures, which should be assessed without regard to the legal form of ownership or the proportion of voting interest held. Joint control contemplates joint decision making over key decisions such as significant acquisitions and dispositions and issuance or repurchase of equity interests, among others. We believe that joint control exists only if all significant decisions are subject to unanimous consent by all venturers.

If reporting entity exercises its decision-making authority through a means other than a voting equity investment (e.g., through a management services contract in which the decision maker or service provider cannot be removed), the entity would not be a joint venture for applying the business scope exception. In such situations, we believe, by design, the holders of the entity’s equity investment at risk do not have the power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance (see Section 7.3.1). Consequently, we believe that it would generally be inappropriate for reporting entities holding variable interests in such entities to use the joint venture scope exception.

Determining whether an entity is a joint venture will depend on the facts and circumstances and will require the use of professional judgment. See our FRD, Joint ventures, for further guidance.
4.4.4.2.2 Determining whether an entity is a franchisee

Assuming the other conditions of the business scope exception do not exist, a reporting entity that participated significantly in the design or redesign of a franchisee that is a business (as defined by ASC 805) is not required to apply the provisions of the Variable Interest Model.

An entity should be considered a franchisee if it is a business (as defined by ASC 805) operating within a defined geographical area subject to a written agreement (the Franchise Agreement) between an investor in the entity and a party (the Franchisor) who has granted business rights to the investor.

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Glossary</td>
</tr>
<tr>
<td>952-10-20</td>
</tr>
<tr>
<td>Franchise Agreement</td>
</tr>
<tr>
<td>A written business agreement that meets the following principal criteria:</td>
</tr>
<tr>
<td>a. The relation between the franchisor and franchisee is contractual, and an agreement, confirming the rights and responsibilities of each party, is in force for a specified period.</td>
</tr>
<tr>
<td>b. The continuing relation has as its purpose the distribution of a product or service, or an entire business concept, within a particular market area.</td>
</tr>
<tr>
<td>c. Both the franchisor and the franchisee contribute resources for establishing and maintaining the franchise. The franchisor’s contribution may be a trademark, a company reputation, products, procedures, manpower, equipment, or a process. The franchisee usually contributes operating capital as well as the managerial and operational resources required for opening and continuing the franchised outlet.</td>
</tr>
<tr>
<td>d. The franchise agreement outlines and describes the specific marketing practices to be followed, specifies the contribution of each party to the operation of the business, and sets forth certain operating procedures that both parties agree to comply with.</td>
</tr>
<tr>
<td>e. The establishment of the franchised outlet creates a business entity that will, in most cases, require and support the full-time business activity of the franchisee. (There are numerous other contractual distribution arrangements in which a local businessperson becomes the authorized distributor or representative for the sale of a particular good or service, along with many others, but such a sale usually represents only a portion of the person’s total business).</td>
</tr>
<tr>
<td>f. Both the franchisee and the franchisor have a common public identity. This identity is achieved most often through the use of common trade names or trademarks and is frequently reinforced through advertising programs designed to promote the recognition and acceptance of the common identity within the franchisee’s market area.</td>
</tr>
<tr>
<td>The payment of an initial franchise fee or continuing royalty fee is not a necessary criterion for an agreement to be considered a franchise agreement.</td>
</tr>
</tbody>
</table>

We believe that analogies generally should not be made to the scope exceptions to the Variable Interest Model. Therefore, we believe that the franchise scope exception should apply only to franchisees (or operating joint ventures).
4.4.3 **Substantially all of the activities of an entity either involve or are conducted on behalf of a reporting entity**

The assessment of whether substantially all of an entity's activities either involve, or are conducted on behalf of, a variable interest holder is a judgment that should be based on an assessment of the facts and circumstances. Although the amount of the entity's economics attributable to the variable interest holder should be considered, we believe the determination of whether substantially all of the activities of an entity involve or are conducted on behalf of a variable interest holder should not be based primarily on a quantitative analysis. We believe the activities of the entity under evaluation should be compared to those of the variable interest holder and its related parties.

Factors that should be considered in determining whether substantially all of the activities of the entity involve or are conducted on behalf of the variable interest holder and its related parties include:

- Are the entity's operations substantially similar in nature to the activities of the variable interest holder?
- Are the majority of the entity's products or services bought from or sold to the variable interest holder?
- Were substantially all of the entity's assets acquired from the variable interest holder?
- Are employees of the variable interest holder actively involved in managing the operations of the entity?
- Do employees of the entity receive compensation tied to the stock or operating results of the variable interest holder?
- Is the variable interest holder obligated to fund operating losses of the entity, if they occur?
- Has the variable interest holder outsourced certain of its activities to the entity?
- If the entity conducts research and development activities, does the variable interest holder have the right to purchase any products or intangible assets resulting from the entity's activities?
- Has a significant portion of the entity's assets been leased to or from the variable interest holder?
- Does the variable interest holder have a call option to purchase the interests of the other investors in the entity? (Fixed-price and “in the money” call options likely are stronger indicators than fair value call options.)
- Do the other investors in the entity have an option to put their interests to the variable interest holder? (Fixed-price and “in the money” put options likely are stronger indicators than fair value put options.)

4.4.4 **A reporting entity and its related parties have provided more than half of an entity's subordinated financial support**

Subordinated financial support refers to variable interests that will absorb some or all of an entity's expected losses. The determination of the amount of subordinated financial support provided to an entity by a reporting entity should be based on a comparison of the fair value of the subordinated financial support provided by the reporting entity to the fair value of the entity's total subordinated financial support.
Illustration 4-6: Determining the amount of subordinated financial support provided by a reporting entity

Assume a reporting entity, Investco, has provided subordinated financial support to a business, Bizco. In determining whether it can apply the business scope exception, Investco obtains the following information regarding the capital structure of Bizco:

<table>
<thead>
<tr>
<th>Subordinated financial support</th>
<th>Book basis</th>
<th>Fair value basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$ 500</td>
<td>$ 400</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>700</td>
<td>500</td>
</tr>
<tr>
<td>Common stock</td>
<td>1,000</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>$ 2,200</td>
<td>$ 1,000</td>
</tr>
</tbody>
</table>

Analysis

In this example, because Investco has provided more than half of Bizco’s subordinated financial support, on a fair value basis (66%, or $1,000 divided by $1,500), it is unable to apply the scope exception to the variable interests it holds in Bizco.

In certain circumstances, a variable interest holder may also provide a guarantee on the debt of the entity. In these circumstances, we generally believe that it is appropriate to include the fair value of the underlying debt subject to the guarantee when determining the amount of subordinated financial support provided by the variable interest holder.

Question 4.5

May a reporting entity apply the business scope exception because another party was able to use that scope exception? Or, should each party to an entity separately evaluate whether the business scope exclusion criteria have been met?

We believe each reporting entity with a variable interest in an entity should determine whether it is eligible for the business scope exception. We do not believe it would be appropriate for a reporting entity to determine whether it is eligible for the business scope exception based on any other reporting entity’s ability to use that exception. For example, assume Investor X and Investor Y each have variable interests in Business B and provide 35% and 55%, respectively, of the total subordinated financial support to the entity based on an analysis of the fair values of the entity’s interests. Assuming none of the conditions identified in the business scope exception exist, Investor X need not apply the Variable Interest Model’s provisions to its variable interests in Business B because it does not provide more than half of the subordinated financial support to the entity. Investor Y, however, must apply the Variable Interest Model to its variable interests in Business B because it provides more than half of the subordinated financial support to the entity.

4.4.5 Private company accounting alternative

The FASB issued ASU 2014-07, which allows private companies to choose to be exempt from applying the Variable Interest Model to lessors in common control leasing arrangements that meet certain criteria. The FASB’s goal is to allow private companies to simplify their accounting for these arrangements, while continuing to provide relevant information to users of private company financial statements.
The guidance, which was developed by the PCC, requires private companies to make an accounting policy election and apply the accounting to all current and future leasing arrangements that meet the criteria. A private company that elects this alternative would need to make certain disclosures about any qualifying arrangements. It also would continue to apply other consolidation guidance in ASC 810 and other applicable US GAAP to the arrangements, such as ASC 460 and ASC 840.

The PCC developed this alternative in response to concerns raised by private company financial statement users and preparers that, in some cases, applying the Variable Interest Model led private companies to consolidate lessors in common control leasing arrangements. These stakeholders said private companies design common control arrangements primarily for tax, estate-planning or legal liability purposes, not to structure off-balance sheet debt, and consolidation doesn’t provide useful information. They noted that financial statement users generally focus on a private company’s cash flows and financial position on a standalone basis. In some cases, users were requesting consolidation schedules to reverse the effects of consolidating the lessor in these arrangements.

Like the other alternatives developed by the PCC, ASU 2014-07 applies to companies that do not meet the FASB's broad new definition of a public business entity. It doesn’t apply to not-for-profit entities and employee benefit plans.

Under the ASU, a private company can choose to apply the alternative when all of the following criteria are met:

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

See Appendix D for further information, including considerations for each of the criteria, illustrations, disclosures, effective date and transition.
5 Evaluation of variability and identifying variable interests

5.1 Introduction

Excerpt from Accounting Standards Codification
Consolidation – Overall
Recognition – Variable Interest Entities
810-10-25-21
The variability that is considered in applying the Variable Interest Entities Subsections affects the
determination of all of the following:
a. Whether the legal entity is a VIE
b. Which interests are variable interests in the legal entity
c. Which party, if any, is the primary beneficiary of the VIE.

That variability will affect any calculation of expected losses and expected residual returns, if such a
calculation is necessary. Paragraph 810-10-25-38A provides guidance on the use of a quantitative
approach associated with expected losses and expected residual returns in connection with
determining which party is the primary beneficiary.

Entities are generally designed to create risk(s), and risk results in variability. The variability an entity is
expected to create (i.e., expected variability) may be positive or negative. The Variable Interest Model
refers to negative variability as “expected losses” and positive variability as “expected residual returns.”
Reporting entities may hold variable interests in an entity that absorb some or all of the expected losses and
expected residual returns created by an entity.

As described in Section 2.6, expected losses and expected residual returns are not GAAP economic
losses or profits. Rather, an entity’s expected losses and expected residual returns are defined as the
negative or positive variability in the fair value of an entity’s net assets, exclusive of variable interests.
Therefore, all entities that have the potential for multiple possible outcomes will have expected losses.
Even entities that have a history of profitable operations and expect to be profitable in the future have
expected losses.
Illustration 5-1: Expected losses

An entity has generated net income of $10 million to $13 million in each of its 10 years of operation. At 31 December 20X9, the entity is expected to generate average net income of $14 million over the next few years. Although the entity is expected to remain profitable, its future net income is an estimate that has uncertainty or variability associated with it and that variability is the source of expected losses. In developing its estimate of average future net income, assume the entity believes its net income could vary between $12 million and $16 million as follows:

<table>
<thead>
<tr>
<th>Expected net income</th>
<th>$14 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected losses</td>
<td>$12 million</td>
</tr>
<tr>
<td></td>
<td>$16 million</td>
</tr>
</tbody>
</table>

Analysis

Although the entity has been profitable historically and is expected to remain profitable, it has expected losses because there is variability around its mean, or expected outcome, of $14 million. Any possible outcome with net income of less than $14 million gives rise to expected losses. Conversely, any possible outcome that produces more than $14 million of net income gives rise to expected residual returns. See Appendix A for additional guidance on the calculation of expected losses and expected residual returns.

Variable interests are interests that absorb the expected variability an entity was designed to create. A reporting entity may be exposed to a number of risks through the interests it holds in an entity, but the Variable Interest Model considers only interests that absorb variability the entity was designed to create and distribute. After determining the variability to consider, a reporting entity can then identify which interests absorb that variability. As described further below, determining the variability an entity was designed to create and identifying variable interests often can be determined based upon a qualitative assessment.

5.2 Step-by-step approach to identifying variable interests

Excerpt from Accounting Standards Codification

Consolidation – Overall

Recognition – Variable Interest Entities

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).
ASC 810-10-25-22 requires a reporting entity to evaluate the design of an entity as the basis for determining the entity’s variability in applying the Variable Interest Model. The “by design” approach is a qualitative approach that considers (1) the nature of the risks in the entity and (2) the purpose for which the entity was created in determining the variability the entity is designed to create and pass along to its interest holders.

To provide more clarity, we have elaborated on the steps listed in ASC 810-10-25-22 and believe that the provisions of the Variable Interest Model should be applied as follows:

**Step 1:** Determine the variability the entity was designed to create and distribute
- **Consideration 1:** What is the purpose for which the entity was created?
- **Consideration 2:** What is the nature of the risks in the entity?

**Step 2:** Identify variable interests
- **Consideration 1:** Which variable interests absorb the variability designated in Step 1?
- **Consideration 2:** Is the variable interest in a specified asset of a VIE, a silo or a VIE as a whole?

We describe each of these steps in more detail below.

### 5.2.1 Step 1: Determine the variability an entity was designed to create and distribute

**Excerpt from Accounting Standards Codification**

<table>
<thead>
<tr>
<th>Consolidation</th>
<th>Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognition</td>
<td>Variable Interest Entities</td>
</tr>
</tbody>
</table>

**810-10-25-29**

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

Determining the variability an entity was designed to create and identifying variable interests generally requires a qualitative assessment that focuses on the purpose and design of an entity. To identify variable interests, it helps to take a step back and ask, “Why was this entity created?” “What is the entity’s purpose?” and “What risks was the entity designed to create and distribute?”

Refer to ASC 810-10-55-55 through ASC 810-10-55-86 for basic examples of how the nature of risks should be identified, the purpose for which the entity was created and the variability the entity was designed to create.
5.2.1.1 Consideration 1: What is the purpose for which the entity was created?

Excerpt from Accounting Standards Codification

Consolidation – Overall
Recognition – Variable Interest Entities

810-10-25-25
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.

810-10-25-27
A review of the terms of the contracts that the legal entity has entered into shall include an analysis of the original formation documents, governing documents, marketing materials, and other contractual arrangements entered into by the legal entity and provided to potential investors or other parties associated with the legal entity.

ASC 810-10-25-25 requires an analysis of the entity’s activities, including which parties participated significantly in the design or redesign of the entity, the terms of the contracts the entity entered into, the nature of the entity’s interests issued and how the entity’s interests were marketed to potential investors. The entity’s governing documents, formation documents, marketing materials and all other contractual arrangements should be closely reviewed and combined with the analysis of the entity’s activities to determine the variability the entity was designed to create.

5.2.1.2 Consideration 2: What is the nature of the risks in the entity?

Excerpt from Accounting Standards Codification

Consolidation – Overall
Recognition – Variable Interest Entities

810-10-25-24
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
While the Variable Interest Model indicates all entity risks should be considered, the “by design” approach does not require that all risks be included in measuring and assigning variability. For example, while an entity may have interest rate risk that is created by periodic interest receipts from its assets, that interest rate risk appropriately should be excluded from applying the provisions of the Variable Interest Model if a reporting entity concludes that the entity was not designed to create and distribute interest rate risk.

5.2.1.2.1 Certain interest rate risk

Excerpt from Accounting Standards Codification

Consolidation — Overall

Recognition – Variable Interest Entities

810-10-25-33

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.

A question that often arises is whether counterparties to market-based interest rate swaps and other absorbers of interest rate risk have variable interests.

We believe that determining whether an entity was designed to create and pass on variability from periodic interest receipts or payments requires careful consideration of the specific facts and circumstances of the entity’s design. We believe variability from periodic interest receipts or payments generally may be excluded if there is interest rate risk in an entity and that mismatch is reduced through an interest rate swap agreement or other instrument that is based on a market observable index and is equal in priority to at least the most senior interest in the entity.

Conversely, if there is an interest rate risk in an entity (e.g., due to a mismatch) that is absorbed by an instrument that is either not based on a market observable index or not at least equal in priority to at least the most senior interest in the entity, variability from periodic receipts or payments generally should be included in the entity’s total variability. See Section 5.4.4 for further guidance on derivative instruments.

Illustration 5-2: Evaluating variability from periodic interest receipts/payments

Example 1

Assume an entity has the following balance sheet:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>B-Rated bond – Fixed interest rate</td>
<td>$ 100 Senior debt – Floating rate</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The entity enters into a fixed to floating (LIBOR) interest rate swap with an $80 notional amount that has at least the same priority of payment as the senior debt. Variability in the value of the entity’s asset will result from changes in market interest rates and the credit risk of the B-rated bond.

Analysis

We believe that because LIBOR is a market observable variable and the interest rate swap is pari passu or senior relative to other interest holders in the entity, the interest rate swap is not a variable interest even though economically 80% of the interest rate variability in the fair value of the bond will be absorbed or received by the swap counterparty. Consequently, the interest rate swap would be considered a creator of interest rate variability (see Section 5.4.4).
If the entity did not enter into an interest rate swap, the variability otherwise absorbed by the interest rate swap counterparty would be absorbed by the equity holder. Because the interest rate variability would be absorbed by the equity holder, we believe interest rate variability from periodic receipts or payments would be included in the variability of the entity.

**Example 2**

Assume an entity has the following balance sheet:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>B-Rated Bond – Floating rate</td>
<td>Senior debt – Fixed rate</td>
</tr>
<tr>
<td>$100</td>
<td>Equity</td>
</tr>
</tbody>
</table>

The entity enters into a floating (LIBOR) to fixed interest rate swap with an $80 notional amount that has at least the same priority of payment as the senior debt.

**Analysis**

Because the interest rate swap is based on a market observable index and has the same level of seniority as the most senior interest, it is not a variable interest even though economically 80% of the interest rate variability from cash flows of the bond will be absorbed or received by the swap counterparty. Consequently, if the entity was not designed to create interest rate risk from periodic interest receipts, the only variability in the entity would be due to the credit risk of the B-rated bond.

If the entity did not enter into an interest rate swap, the variability otherwise absorbed by the interest rate swap counterparty would be absorbed by the equity holder. Because the interest rate variability would be absorbed by the equity holder, we believe interest rate variability from periodic receipts/payments would be included in the variability of the entity.

**Question 5.1** Should prepayment risk be evaluated separately from interest rate risk in determining the risks the entity was designed to create and distribute to its interest holders?

In determining the risks the entity is designed to create and distribute, we believe prepayment risk should not be considered separately from interest rate risk that arises from periodic receipts. That is, if an entity is designed to create and distribute prepayment risk, we generally believe the entity also was designed to create interest rate risk arising from periodic receipts. For example, residential mortgage loans often have prepayment provisions that create variability. If the loans’ prepayment risk is considered substantive, we believe that prepayment risk and the interest rate variability arising from periodic interest receipts should be used in calculating expected losses and expected residual returns if such a calculation is deemed necessary.

In these circumstances, we believe use of the fair value method may be required to measure variability because of the cause and effect relationship between changes in interest rates and prepayments. See Section 5.3 and Appendix A for guidance on the three methods used to calculate expected losses and expected residual returns.

To determine the variability an entity was designed to create, a reporting entity also should consider the terms of interests issued by an entity and whether those interests are subordinated.
5.2.1.2.2 Terms of interests issued

Excerpt from Accounting Standards Codification

Consolidation – Overall
Recognition – Variable Interest Entities
810-10-25-31
An analysis of the nature of the legal entity’s interests issued shall include consideration as to whether the terms of those interests, regardless of their legal form or accounting designation, transfer all or a portion of the risk or return (or both) of certain assets or operations of the legal entity to holders of those interests. The variability that is transferred to those interest holders strongly indicates a variability that the legal entity is designed to create and pass along to its interest holders.

The determination of whether an interest is a variable interest should not be based solely on the legal or accounting designation. See Illustration 5-3.

5.2.1.2.3 Subordination

Excerpt from Accounting Standards Codification

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

The absorption of risks by substantive subordinated interests issued by the entity is a strong indicator of the variability that the entity is designed to create. If the subordination in the entity is substantive, the entity is likely designed to create and distribute credit risk.

We believe that the determination of whether an interest’s subordination is substantive can often be made qualitatively. This evaluation should consider the entity’s activities, including terms of the contracts the entity has entered into and how the interests were negotiated with or marketed to potential investors. We believe the following factors should be considered in determining whether an interest’s subordination is substantive:

- Relative size of the debt tranches and equity issued – For example, the greater the ratio of equity to debt, the more likely that the subordination is substantive.
- Amount and relative size of investment grade ratings of the debt tranches issued, including their relative size to total of debt tranches and equity issued – For example, the more disparate the investment grade ratings, the more likely that the subordination is substantive.
Evaluation of variability and identifying variable interests

- Effective interest rates on the various interests issued – For example, the more disparate the interest rates, the more likely that the subordination is substantive.

- Comparison of assets’ average investment grade rating to most senior beneficial interests’ ratings – For example, the more disparate the ratings, the more likely that the subordination is substantive.

- Comparison of total expected losses and expected residual returns to the amount of the subordinated interests – For example, the larger the ratio of subordinated interests to expected losses and expected residual returns becomes, the more likely that the subordination is substantive.

Equity investments generally represent the most subordinated interests in an entity. However, we believe the terms of equity investments should be carefully evaluated in determining whether subordination of the interests in the entity is substantive. One factor to consider is whether an equity investment is at risk. For example, an entity may issue equity that is puttable by the investor to the entity at its purchase price. In that case, the equity investment would not be at risk pursuant to ASC 810-10-15-14(a)(1) because it does not participate significantly in losses. As a result, the equity investment would not be considered in determining whether subordination is substantive because the investor is not contractually required to absorb the entity’s losses.

The subordination of equity that is at risk but not sufficient to absorb expected losses pursuant to ASC 810-10-15-14(a) may be considered substantive for determining the variability an entity is designed to create and distribute. For example, assume an entity has $100 of assets that are financed with $80 of senior debt, $10 of subordinated debt and $10 of equity. If the entity’s expected losses are greater than $10, the equity would not be sufficient because the subordinated debt also would absorb some of the entity’s expected losses. However, the subordination of both the equity investment and debt instrument may still be considered substantive. If, after considering all of the facts and circumstances, the equity investment and debt instrument are deemed substantive subordinated interests, they would be strong indicators that the entity is designed to create and distribute credit risk.

5.2.2 Step 2: Identify variable interests

**Excerpt from Accounting Standards Codification**

*Consolidation – Overall*

*Recognition – Variable Interest Entities*

**810-10-25-23**

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.

After determining the variability to consider, a reporting entity can then identify which interests absorb that variability. A reporting entity must determine whether it has a variable interest in the entity being evaluated for consolidation. A reporting entity that does not have a variable interest in an entity is not subject to consolidating that entity under ASC 810 and would consider other GAAP.
5.2.2.1 Consideration 1: Which variable interests absorb the variability designated in Step 1?

Excerpt from Accounting Standards Codification

Consolidation — Overall
Recognition — Variable Interest Entities
810-10-25-26
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.

Implementation Guidance and Illustrations — Variable Interest Entities
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.

810-10-55-18
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.

810-10-55-19
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.

As described in Section 2.15, variable interests are defined as contractual, ownership (equity) or other financial interests in an entity that change with changes in the fair value of the entity's net assets. For example, a traditional equity investment is a variable interest because its value changes with changes in the fair value of the company's net assets. Another example would be a reporting entity that guarantees an entity's outstanding debt. Similar to an equity investment, the guarantee provides the reporting entity with a variable interest in the entity because the value of the guarantee changes with changes in the fair value of the entity's net assets.

The labeling of an item as an asset, liability, equity or contractual arrangement does not determine whether that item is a variable interest. Variable interests can be assets, liabilities, equity or contractual arrangements. A key distinguishing factor of a variable interest from other interests is its ability to absorb or receive the variability an entity was designed to create and pass along to its interest holders. Interests that absorb risks the entity was not designed to create are considered part of the entity's net assets and are not variable interests in the entity. Interests that introduce risk to an entity generally are not variable interests in the entity.
Guarantees, subordinated debt interests and written call options are variable interests because they absorb risk created and distributed by the entity. Items such as forward contracts, derivative contracts, purchase or supply arrangements and fees paid to decision makers or service providers may represent variable interests depending on the facts and circumstances. These items require further evaluation and are discussed in detail in Section 5.4.

ASC 810-10-25-26 states that the role of a contract or arrangement in the design of an entity—regardless of its legal form or accounting classification—dictates whether that contract or arrangement is a variable interest. We believe the economics underlying the entity's transactions, and not their accounting or legal forms, should be used in identifying variable interests.

Illustration 5-3: Identification of variable interests based on underlying economics

Company A transfers financial assets ($500) to a newly created entity that will pay for the transferred assets by issuing senior beneficial interests ($400) to unrelated third parties. Company A retains a subordinated interest ($100) in the transferred financial assets. Assume that while the transfer legally isolates the transferred assets from Company A, Company A is required to account for the transaction as a secured borrowing pursuant to ASC 860.

Analysis

We believe the provisions of the Variable Interest Model should be applied based on the entity's underlying economics and not how the transferor accounted for the transfer. We believe the entity was designed to be exposed to the credit risk of the transferred assets. While for accounting purposes the entity's asset is a receivable from the transferor (i.e., Company A), the entity is not exposed to the transferor's credit risk because legally, the entity holds title to the transferred assets. Even though the entity does not recognize the transferred assets for accounting purposes, economically, the senior beneficial interest holders are exposed to variability in the transferred assets and are not exposed to variability in the transferor's credit risk.

Assuming the subordination is substantive, we believe the entity was designed to create and distribute credit risk from the transferred assets. Company A (through its retained interest) and senior beneficial interest holders would each have variable interests in the entity.

Illustration 5-4: Identification of variable interests based on underlying economics—product financing arrangements (modified from Case F in ASC 810-10-55-75:77)

Assume an entity is created by a furniture manufacturer and a financial investor to sell furniture to retail customers in a particular region. To create the entity, the furniture manufacturer contributes $100 and the financial investor contributes $200. The entity has entered into a fixed price purchase agreement to buy inventory from the furniture manufacturer, but it can sell back any purchased inventory to the furniture manufacturer for cost at any time.

Analysis

We believe that the furniture manufacturer is not able to record the sale of the inventory to the entity for accounting purposes through application of ASC 470-40, but the entity has economic exposure to price declines of the inventory through the fixed price purchase agreement. Accordingly, inventory price risk is a risk the entity was designed to create and distribute to its interest holders. The furniture manufacturer absorbs the inventory price risk through the put option written to the entity and, accordingly, has a variable interest in the entity.

The entity generally is also exposed to sales volume and price risk, operating cost risk and the credit risk of the furniture manufacturer.
Because the “by design” approach is applied after considering all relevant facts and circumstances, certain instruments that may otherwise appear to absorb the entity’s risks may not be considered variable interests. For example, ASC 810-10-55-81 through 55-86 illustrate how an entity may be designed to provide financing through a combination of forward contracts – both purchases and sales. While some contracts may appear to absorb risk, the design of the entity indicates that neither forward is a variable interest. That is, both instruments are considered to be creators of variability. The “by design” approach requires professional judgment, based on consideration of all relevant facts and circumstances.

### 5.2.2.2 Consideration 2: Is the variable interest in a specified asset of a VIE, a silo or a VIE as a whole?

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Implementation Guidance and Illustrations — Variable Interest Entities**

**810-10-55-21**

Paragraphs 810-10-55-16 through 55-41 also do not discuss whether the variable interest is a variable interest in a specified asset of a VIE or in the VIE as a whole. Guidance for making that determination is provided in paragraphs 810-10-25-55 through 25-56. Paragraphs 810-10-25-57 through 25-59 provide guidance for when a VIE shall be separated with each part evaluated to determine if it has a primary beneficiary.

The Variable Interest Model has special provisions to determine whether a reporting entity with a variable interest in specified assets of an entity has a variable interest in the entity as a whole. This determination is important because if a party has a variable interest only in specified assets of a VIE but does not have a variable interest in the VIE as a whole, it cannot be required to consolidate the VIE. See Section 5.5 for further guidance on variable interests in specified assets.

However, a reporting entity with a variable interest in specified assets of a VIE should carefully consider whether those specified assets represent a silo that requires separate analysis from the larger host VIE. A silo can be consolidated separately from the host entity when the host entity is a VIE. See Chapter 6 for further guidance on determining whether silos exist.

### 5.3 Quantitative approach to identifying variable interests

A qualitative assessment can often be performed to determine the variability an entity was designed to create and to identify variable interests, as discussed in Section 5.2.

However, in some cases, a quantitative approach may be needed to identify variable interests. For example, a quantitative approach likely will be used when determining whether a reporting entity has a variable interest in specified assets, as discussed in Section 5.5. We are aware of three primary methods used to calculate expected losses and expected residual returns when determining the variability an entity was designed to create: fair value, cash flow and cash flow prime. The methods differ based on how the underlying cash flows are projected and discounted. The method a reporting entity selects to measure variability should ensure that the variability associated with the entity’s designed risks are appropriately measured and allocated to the entity’s variable interest holders. The methods used to calculate expected losses and expected residual returns are described more fully in Appendix A of this publication.
5.4 Illustrative examples of variable interests

Excerpt from Accounting Standards Codification

Consolidation — Overall

Implementation Guidance and Illustrations — Variable Interest Entities

810-10-55-20

Paragraphs 810-10-55-16 through 55-41 describe examples of variable interests in VIEs subject to the Variable Interest Entities Subsections. These paragraphs are not intended to provide a complete list of all possible variable interests. In addition, the descriptions are not intended to be exhaustive of the possible roles, and the possible variability, of the assets, liabilities, equity, and other contracts. Actual instruments may play different roles and be more or less variable than the examples discussed. Finally, these paragraphs do not analyze the relative significance of different variable interests, because the relative significance of a variable interest will be determined by the design of the VIE. The identification and analysis of variable interests must be based on all of the facts and circumstances of each entity.

The Codification provides some examples of variable interests in VIEs. This section highlights those and other examples commonly seen in practice.

5.4.1 Equity investments

Excerpt from Accounting Standards Codification

Consolidation — Overall

Implementation Guidance and Illustrations — Variable Interest Entities

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.

The most apparent form of variable interest is equity investments. Equity investments generally represent the most subordinated interests in an entity. The equity investors provide capital to an entity and receive ownership interests that provide the investors with residual claims on assets after all liabilities are paid. Through their equity investments, equity investors absorb expected losses and expected residual returns in an entity. However, there are circumstances when equity investments may not absorb expected variability, as described in Section 7.2, and thus may not represent variable interests.

5.4.1.1 Interests held by employees

Questions have arisen as to whether variable interests in an entity held by a reporting entity’s employees are considered to be the reporting entity’s own variable interests. Regardless of whether interests held by employees are financed (through a loan or contribution) by the reporting entity, we do not believe that interests held by employees are considered variable interests held by the reporting entity, unless they are used to circumvent the Variable Interest Model.

See Section 5.4.13.2.2 for considerations with respect to interests held by employees in the context of analyzing whether a fee is a variable interest.
These evaluations differ from how interests held by employees are considered in the primary beneficiary analysis. As discussed in Section 9.2, when identifying the primary beneficiary of an entity, if an employee owns an interest in the entity being evaluated and that employee's interest has been financed by the reporting entity, the reporting entity would include that financing as its indirect interest in the determination of primary beneficiary. The inclusion of an employee's financed interest in the primary beneficiary determination would only be considered if the reporting entity has other variable interests in the VIE but the reporting entity does not individually have power and benefits.

5.4.2 Beneficial interests and debt instruments

Excerpt from Accounting Standards Codification

Consolidation – Overall

Implementation Guidance and Illustrations – Variable Interest Entities

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.

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.

Reporting entities that provide financing to an entity receive fixed or variable returns. Whether the lender receives a return is affected by the ability of the entity to make payments on its financing obligations, which in turn is affected by the entity’s operating performance. As a result, substantially all debt instruments are variable interests, including senior debt.

The seniority or subordination of debt is relative to other debt securities or tranches issued by an entity. Therefore, even senior debt could be considered subordinated debt if it ranks below other levels of senior debt and is expected to absorb some or all of a VIE’s expected losses. In general, all forms of debt financing are “subordinated financial support” unless the financing is the most senior class of liabilities and is considered investment-grade. Investment-grade means a rating that indicates that debt has a relatively low risk of default. If the debt is not rated, it should be considered investment-grade only if it possesses characteristics that warrant such a rating.

5.4.3 Trust preferred securities

Trust preferred securities have been marketed under a variety of acronyms such as TruPS (Trust Preferred Securities), MIPS (Monthly Income Preferred Stock), QUIPS (Quarterly Income Preferred Stock), QUICS (Quarterly Income Capital Securities) and TOPrS (Trust Originated Preferred Redeemable Stock). These securities have generally been treated as debt for tax purposes but, for some financial institutions, qualify as Tier I capital for regulatory purposes.
Typically, a sponsor does not have a variable interest in the trust. Because these structures can vary, the evaluation of whether a sponsor has a variable interest is based on individual facts and circumstances. The sponsor of a trust preferred securities arrangement may have a variable in the trust in certain cases.

The following summarizes a typical trust preferred securities arrangement.

- A sponsor organizes a newly-formed entity, usually in the form of a Delaware business trust (i.e., the trust).
- The sponsor purchases all of the trust's common equity securities or finances the purchase of the common equity securities directly with the trust. Typically, the common equity interest represents 3% of the overall equity of the trust, but it could be more.
- The trust issues preferred securities to investors.
- The trust uses the proceeds from the preferred securities issuance and the proceeds (if any) from the common equity securities issuance to purchase deeply subordinated debentures, with terms often identical or similar to those of the trust preferred securities, from the sponsor.
- The debentures typically are callable by the trust at par at any time after a specified period (typically five years).
- Typically, the trust has written a call option permitting the sponsor to settle the debentures and also has purchased a call option to settle the securities issued to the preferred investors.
- The trust uses interest payments received from the sponsor to pay periodic dividends to the preferred investors.
- Finally, the sponsor may provide a performance guarantee limited to the trust’s activities rather than the credit worthiness of the trust (i.e., the sponsor may guarantee that the trust will make principal and interest payments on the preferred securities if the trust has the cash to make those payments but does not guarantee those proceeds will be available through the guarantee).

Typically, in these arrangements, the trust's preferred investors have the rights of preferred shareholders and do not have creditor rights unless the sponsor directly issues an incremental credit guarantee to the investors. Additionally, the trust's preferred investors generally do not have voting rights in the trust. However, if the sponsor defaults on its issued debentures, the trustee can pursue its rights as a creditor. In some arrangements, however, the trust's preferred investors may have the right to act directly against the sponsor.
The following diagram summarizes the cash flows for a typical issuance of trust preferred securities. The diagram does not include guarantees and other arrangements between the parties for simplicity.

**Offering flows**

1. **Sponsor**
   - Organizes a newly-formed entity, usually in the form of a Delaware business trust, and purchases all of the trust’s common equity securities.

2. **Trust**
   - Issues trust preferred securities to Preferred investors for cash.

3. **Cash proceeds**
   - Use proceeds of the sale of the common securities (if any) and the trust preferred securities to purchase deeply subordinated debentures from Sponsor, with terms often identical or similar to those of the trust preferred securities.

4. **Subordinated debentures**

5. **Preferred investors**
This diagram summarizes the operating cash flows between Sponsor, Trust and Investors.

**Operating cash flows**

1. Sponsor makes periodic interest payments on its subordinated debentures to Trust.

2. Trust uses debenture interest payments (received from Sponsor) to pay periodic dividends on trust preferred securities to Preferred investors.

3. Preferred investors receive interest income.

**Holders of variable interests in the trust**

Preferred investors: Each of the trust’s preferred investors is exposed to variability in the performance of the trust and, therefore, has a variable interest in the trust.

Sponsor: The sponsor’s common stock investment typically is not a variable interest because an equity investment is a variable interest only if the investment is considered to be at risk. Because the sponsor’s investment in the trust’s common stock often is funded by the trust (through the loan), it is not considered to be at risk (see ASC 810-10-55-22 and Section 5.4.1 for additional guidance). Additionally, sponsor’s issued debentures and the related call option create rather than absorb the variability of the trust. Finally, any guarantee provided by the sponsor is effectively a guarantee of its own performance (i.e., the trust is only able to pay interest and principal to preferred investors if the sponsor pays interest and principal on its debentures issued to the trust), and is therefore not considered a variable interest.
Other structures

We are aware of some structures in which an intermediary entity exists between what would otherwise be the typical sponsor and trust as described above. In these structures, the intermediary entity may exist for tax reasons and effectively acts as an additional trust through which securities are issued and proceeds are received. Following the entity by entity approach to consolidation evaluations, the trust that ultimately issues the trust preferred securities to outside investors should carefully consider whether it is the primary beneficiary of the intermediary trust.

5.4.4 Derivative instruments

Derivative instruments may absorb a risk the entity was designed to create and distribute, but may not be considered variable interests. ASC 810-10-25-35 indicates that a derivative instrument generally is not a variable interest if it has an underlying that is a market observable variable and is with a counterparty that is exposed to little or no credit risk of the entity due to its seniority relative to other holders in the entity. For example, certain interest rate swaps may absorb the entity’s interest rate variability, but if the underlying is based on LIBOR and amounts payable to the derivative counterparty are senior relative to other interest holders in the entity, it would not be considered a variable interest, regardless of the method selected to measure variability.

Excerpt from Accounting Standards Codification

Consolidation — Overall

Recognition — Variable Interest Entities

810-10-25-34
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.

810-10-25-35
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.

810-10-25-36
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.
Careful consideration of all facts and circumstances is necessary when determining whether a derivative counterparty holds a variable interest. ASC 810-10-25-35 states that a derivative instrument is likely not a variable interest if it (1) is based on an observable market rate, price or index or other market observable variable and (2) exposes its derivative counterparty to little or no credit risk of the entity due to its seniority relative to other interest holders in the entity. The derivative likely is not a variable interest even if the derivative instrument economically absorbs the variability the entity was designed to create and distribute to its holders, except as provided further below. We do not believe ASC 810-10-25-35 provides a scope exception for derivatives with these characteristics; instead, it states that the characteristics previously described are strong indicators that derivatives are creators of variability. However, if 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 entity, further analysis of the entity's design is required to determine whether the derivative, is a variable interest.

We believe these conditions were created by the FASB to provide practical relief for holders of unsubordinated derivative instruments from reviewing each instrument – particularly “plain vanilla” interest rate and foreign currency swap agreements – to determine whether the instrument absorbs the entity's variability (and potentially to provide the Variable Interest Model's disclosures with respect to the entity). We believe that the derivative contract must meet ASC 815's definition of a derivative instrument in order to apply ASC 810-10-25-35.

We believe that in determining whether a derivative instrument is based on a market-observable variable, the underlying must be observable based on market data obtained from sources independent of the reporting entity or its variable interest holders. In addition, as part of that determination, we believe consideration should be given to whether the underlying is readily convertible to cash, as that term is defined in ASC 815, to qualify as a market observable variable. A market price or rate can be estimated or derived from third-party sources in many circumstances. However, we believe the mere presence of a market quote, without sufficient liquidity in the derivative market or the market for the underlying, would not qualify as an observable market. Therefore, we believe liquidity of the derivative market or the underlying is an important element with respect to satisfying this criterion.

For example, for interest rate swaps, we believe LIBOR is a market observable variable. Similarly, for a foreign currency swap agreement, we believe the spot price for Japanese yen, as a highly liquid currency, would have an underlying that has a market observable rate, but an illiquid currency may not have a market observable rate, even if a quote can be obtained in the marketplace. Judgment will be required to determine whether the underlying is based on a market observable variable.

In order for the derivative instrument to expose the derivative counterparty to little or no credit risk of an entity, we believe that the derivative instrument must be at least pari passu with the instrument that has the most senior claim on the entity's assets.

<table>
<thead>
<tr>
<th>Illustration 5-5: Derivative instruments – credit-linked notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank A, seeking to obtain credit protection on an investment in bonds (Investment Y), enters into a credit default swap with a newly-established trust. Investors purchase credit-linked notes, the proceeds from which are invested in US Treasury securities. Bank A pays a specified premium for credit protection, and, if a credit event occurs (as defined), the trust pays Bank A the notional amount and receives Investment Y. The credit-linked notes are satisfied through delivery of the defaulted bonds or by selling them and issuing cash.</td>
</tr>
</tbody>
</table>
Analysis

While all of the facts and circumstances must be considered, we believe the entity was designed to create and distribute the credit risk of Investment Y. Accordingly, even if the embedded derivative in the credit-linked notes meets conditions (1) and (2) described previously, the value of that embedded derivative is highly correlated with changes in the operations of the entity. That is, the entity’s value is based almost exclusively on the credit of Investment Y, which is the underlying for the credit default swap. Accordingly, the credit default swap issued to Bank A would be a creator of variability. The credit-linked notes are variable interests because they absorb the risk the entity was designed to create and distribute (i.e., the credit risk of Investment Y).

We believe that a similar analysis should be performed for financial guarantee contracts.

Illustration 5-6: Derivative instruments — total return swap

An entity holds one share of common stock of each of the companies listed in the S&P 500, which it purchased by issuing variable-rate debt to Investor Y. The entity enters into a total return swap with Investor X pursuant to which Investor X pays the entity a LIBOR-based rate and receives the total return of the S&P 500.

Analysis

We believe the entity was designed to create and distribute the price risk of the S&P 500 Index. While the S&P 500 Index is a market observable variable, the change in the value of the total return swap is expected to offset essentially all of the risk or return of all of the entity’s assets. Accordingly, we believe Investor X has a variable interest in the entity.

That is, we do not believe it would be appropriate to conclude that because the S&P 500 Index is a market observable variable, the derivative is a creator of variability, pursuant to ASC 810-10-25-35 through 25-36. Rather, based on the purpose and design of the entity, which was to create and distribute price risk of the S&P 500, Investor X has a variable interest.

5.4.4.1 Common derivative contracts

Excerpt from Accounting Standards Codification

Consolidation – Overall

Implementation Guidance and Illustrations – Variable Interest Entities

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.
The following table lists certain common derivative contracts and provides a general framework for determining whether each contract absorbs fair value or cash flow variability. As described in Section 5.2, variable interests are identified after a reporting entity determines the variability the entity was designed to create and distribute and after it applies ASC 810-10-25-35 and 25-36 and considers all facts and circumstances (including whether the derivative instrument is a variable interest in specified assets – see Section 5.5 and Question 5.2). If the derivative instrument does not absorb variability, it is not a variable interest. If the derivative instrument absorbs variability, it may be a variable interest depending on the application of the guidance in ASC 810-10-25-35 and 25-36 as discussed above:

<table>
<thead>
<tr>
<th>VIE instrument</th>
<th>Description</th>
<th>Absorb variability</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Fair Value</td>
</tr>
<tr>
<td>Written put</td>
<td>Counterparty has an option to sell assets to the VIE</td>
<td>No&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>Written call</td>
<td>Counterparty has an option to purchase assets from the VIE</td>
<td>Yes</td>
</tr>
<tr>
<td>Purchased put</td>
<td>VIE has an option to sell assets to the counterparty</td>
<td>Yes</td>
</tr>
<tr>
<td>Purchased call</td>
<td>VIE has an option to purchase assets from the counterparty</td>
<td>No</td>
</tr>
</tbody>
</table>
| Forward to buy | VIE has entered into an arrangement to buy an asset at a fixed price from the counterparty in the future. The derivative instrument can be bifurcated into a:  
  • Written put  
  • Purchased call | No<sup>9</sup> | No<sup>9</sup> |
| Forward sell   | VIE has entered into an arrangement to sell an asset at a fixed price<sup>9</sup> to the counterparty in the future. The derivative instrument can be bifurcated into a:  
  • Purchased put  
  • Written call | Yes | Yes |
| Purchased guarantee | VIE has purchased a put, or the option to sell assets, to the counterparty | Yes | Yes |
| Sold guarantee | Counterparty has purchased a put, or the option to sell assets, to the VIE | No<sup>9</sup> | No<sup>9</sup> |
| Floating for fixed interest rate swap | VIE makes variable interest rate payments on a notional amount to the counterparty in exchange for fixed interest payments | No | Yes |
| Fixed for floating interest rate swap | VIE makes fixed interest rate payments on a notional amount to the counterparty in exchange for floating interest payments | Yes | No |
| Total return swap out | VIE pays total return relating to a specific asset or group of assets to a counterparty in exchange for a fixed return on a notional amount. Analogous to a forward to sell | Yes | Yes |
| Total return swap in | Counterparty pays total return relating to a specific asset or group of assets to the VIE in exchange for a fixed return on a notional amount. Analogous to a forward to buy | No | No |

---

<sup>7</sup> Under either the cash flow method or cash flow prime method

<sup>8</sup> Credit risk should be considered. That is, if there is a significant likelihood that the VIE will be unable to perform according to the terms of the derivative contract due to the nature or amount of its assets, the counterparty may have a variable interest in the VIE.

<sup>9</sup> A forward to sell an asset to the counterparty in the future at the market price on that future date would not be a variable interest in the entity.
5.4.4.2 Forward contracts

Excerpt from Accounting Standards Codification

Consolidation – Overall

*Implementation Guidance and Illustrations – Variable Interest Entities*

810-10-55-27

Forward contracts to buy assets or to sell assets that are not owned by the VIE at a fixed price will usually expose the VIE to risks that will increase the VIE’s expected variability. Thus, most forward contracts to buy assets or to sell assets that are not owned by the VIE are not variable interests in the VIE.

810-10-55-28

A forward contract to sell assets that are owned by the VIE at a fixed price will usually absorb the variability in the fair value of the asset that is the subject of the contract. Thus, most forward contracts to sell assets that are owned by the VIE are variable interests with respect to the related assets. Because forward contracts to sell assets that are owned by the VIE relate to specific assets of the VIE, it will be necessary to apply the guidance in paragraphs 810-10-25-55 through 25-56 to determine whether a forward contract to sell an asset owned by a VIE is a variable interest in the VIE as opposed to a variable interest in that specific asset.

Forward contracts are often challenging to evaluate under the VIE model. Whether fixed price forward contracts absorb or create variability in an entity will often depend on whether there are significant other risks in the entity, other than the volatility in the pricing of the assets in a forward contract. ASC 810-10-55-81 through 55-86 illustrate how a forward purchase contract (i.e., a contract to purchase assets in the future at a fixed price) may be evaluated when considering whether the contract creates or absorbs variability.

Generally, a forward or supply contract to sell assets owned by an entity at a fixed price (or fixed formula) will absorb the variability in the fair value of those assets. Similarly, contracts with certain types of pricing mechanisms such as cost plus also may be variable interests. However, this does not automatically lead to a conclusion that such forward contacts are variable interests in the entity. A careful consideration of the risks associated with the underlying entity and its design must be considered in making this determination. In addition, if the contract relates to specified assets that comprise less than 50% of the fair value of the entity’s total assets, the contract would not be a variable interest in the entity (See Section 5.5 for guidance on variable interests in specified assets).

A forward to sell an asset to a counterparty in the future at the market price on that future date would not be a variable interest in the entity.

5.4.4.3 Total return swaps

Excerpt from Accounting Standards Codification

Consolidation – Overall

*Recognition – Variable Interest Entities*

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.
Total return swaps and similar arrangements may be used to transfer the risk or returns related to certain assets without actually transferring the assets. The design of the entity determines whether the swap counterparty has a variable interest in the entity. Paragraphs ASC 810-10-25-35 and 25-36 indicate that if the total return swap does not have an underlying that is a market observable variable or is not senior relative to other interest holders, it is a variable interest. If the total return swap's underlying is a market observable variable and its payment priority is of at least that of the most senior interest holder, ASC 810-10-25-35 and 25-36 indicate the total return swap may be a variable interest if changes in the value of the total return swap 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 entity.

When evaluating whether a total return swap or similar arrangement is a variable interest, a swap counterparty should determine whether the total return swap is a variable interest in a silo or the entity as a whole. A silo may exist if the referenced asset, or group of assets, are held by the entity and are essentially the only source of payments for specified liabilities or specified other interests (see Chapter 6 for guidance on silos). In applying ASC 810-10-25-35 and 25-36, to determine whether a total return swap is a variable interest in a silo, we believe the changes in the fair value of the total return swap should be compared with the changes in the fair value of the siloed assets. If the total return swap is a variable interest in the silo, the swap counterparty should determine whether it is the primary beneficiary of the silo.

### Illustration 5-7: Total return swap that represents a variable interest in a silo

An entity, Finco, invests $100 in marketable debt securities maturing in three years. To finance the acquisition of these securities, Finco borrows $100 on a nonrecourse basis. The fair value of Finco's total assets is $500.

Finco enters into a total return swap with a counterparty, Investco, which receives the total returns on the marketable debt securities. In exchange, Investco pays Finco LIBOR plus 50 basis points on a $100 notional for a three-year term. The total return swap is senior relative to the other interest holders in the entity.

#### Analysis

Because the marketable debt securities held by the entity are essentially the only source of payment for the lender, and essentially all of the expected residual returns of these securities have been transferred from the holders of other variable interests in Finco to Investco, the marketable debt securities represent a silo. (Note: Because silos can exist only when the host entity is a VIE, this example assumes Finco is a VIE. See Section 6.2 for further guidance on determining whether a host entity is a VIE when silos exist.)

In addition, because the changes in the value of the total return swap are expected to offset essentially all of the risk for a majority of the silo's assets, we believe Investco has a variable interest in the silo. Accordingly, Investco would be required to determine whether it is the primary beneficiary of the silo.

If the referenced asset or group of assets that is held by the entity is not a silo but the fair value of those assets represents more than one-half of the total fair value of the entity's assets, the swap counterparty should evaluate whether the total return swap is a variable interest in the entity as a whole. If the fair value of the referenced asset or group of assets that is held by the entity is less than half of the fair value of the entity's total assets, the total return swap is an interest in specified assets and is not a variable interest in the entity as a whole. Accordingly, the swap counterparty is not required to apply the provisions of the Variable Interest Model, including disclosures relating to variable interests in VIEs. See Section 5.5 and Chapter 6 for further guidance on variable interests in specified assets and silos, respectively.
Illustration 5-8: Total return swap that represents a variable interest in the entity as a whole

An entity, Finco, has a note receivable from a third party due in three years and bearing interest at 8% per annum. The fair value of the note receivable is $300. The fair value of Finco’s assets, in total, is $500. No silo is assumed to exist.

Finco enters into a total return swap with a counterparty, Investco, which receives the total return on the loan. In exchange, Investco pays Finco LIBOR plus 50 basis points on a $300 notional for a three-year term.

Analysis

Because the changes in the value of the total return swap are expected to offset essentially all of the risk for a majority of Finco’s assets, we believe Investco has a variable interest in Finco as a whole.

5.4.4.4 Embedded derivatives

Excerpt from Accounting Standards Codification

Consolidation — Overall

Recognition – Variable Interest Entities

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.

To determine whether an embedded derivative is clearly and closely related economically to the host instrument, a reporting entity will need to evaluate the applicable facts and circumstances. The evaluation should be based on a comparison of the nature of the underlying in the embedded derivative to the host instrument. We believe that if the underlying that causes the value of the derivative to fluctuate is inherently related to the host instrument, it should be considered clearly and closely related.

If it is clearly and closely related, the embedded derivative is not bifurcated from the host instrument and should be evaluated with the host (as a single instrument) when assessing whether it is a variable interest. For purposes of applying the provisions of the Variable Interest Model, an embedded derivative generally should be considered clearly and closely related economically to the host instrument if the value of the embedded derivative reacts to the effects of changes in external factors in a similar and proportionate manner to the host instrument.

ASC 815 requires that embedded derivatives be bifurcated from the host contract and accounted for in the same manner as freestanding derivatives if certain criteria are met. One criterion in paragraph 815-15-25-1 is that 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. Based on discussions with the FASB staff, we understand that the determination of whether an embedded derivative is a variable interest under ASC 810-10-55-31 should not be based solely on ASC 815’s bifurcation guidance. We believe that ASC 815’s “clearly and closely related” provisions should be viewed similar to the guidance in ASC 810-10-55-31 in the Variable Interest Model.

The following describes common host instruments and their embedded derivatives and whether they generally should be bifurcated and evaluated separately to determine whether the embedded derivative is a variable interest. This guidance primarily is based on ASC 815.
Host debt instruments:

- Interest-rate indices – An interest rate or interest-rate index generally should be considered clearly and closely related to the host debt instrument if (1) a significant leverage factor is not involved or (2) the instrument cannot be settled in a way that the investor would not recover substantially all of its recorded investment.

- Inflation-indexed provisions – Interest rates and the rate of inflation in the economic environment for the currency in which a debt instrument is denominated are clearly and closely related if a significant leverage factor is not involved.

- Credit sensitive payments – The creditworthiness of a debtor and the interest rate on a debt instrument issued by that debtor are clearly and closely related. Thus, interest rates that reset in the event of default, upon a change in the debtor’s credit rating or upon a change in the debtor’s credit spread over US Treasury bonds all would be considered clearly and closely related. However, a reset based on a change in another entity’s credit rating or its default would not be considered clearly and closely related.

- Calls and puts on debt instruments – Call or put options are generally clearly and closely related unless the debt involves a substantial premium or discount (such as found in zero-coupon bonds), and the option is only contingently exercisable.

- Interest-rate floors, caps and collars – Interest rate floors, caps, and collars (i.e., a combination of a floor and cap) within a host debt instrument are generally clearly and closely related if the floor is at or below the current market rate at issuance and the cap is at or above the current market rate at issuance, and there is no leverage.

- Equity-indexed interest payments – Changes in the fair value of a specific common stock or on an index based on a basket of equities are not clearly and closely related to the interest return on a debt instrument.

- Commodity-indexed interest or principal payments – Changes in the fair value of a commodity are not clearly and closely related to the interest return on a debt instrument.

- Conversions to equity features – The changes in fair value of an equity interest and the interest rates on a debt instrument are not clearly and closely related. Thus, conversion to equity features embedded in a host debt instrument issued by a VIE should be accounted for as a variable interest.

Host equity instruments:

- Calls and puts on equity instruments – Put and call options that require the VIE to reacquire the instrument or give the holder the right to require repurchase of the instrument are not clearly and closely related to the equity instrument. An equity instrument host is characterized by a claim to the residual ownership interest in an entity, and put and call features are not considered to possess that same economic characteristic. Additionally, an equity instrument issued by a VIE subject to puts and calls may not qualify as an equity investment at risk for determining whether an entity is a VIE (see Section 7.2 for additional guidance).

Host lease instruments:

- Inflation-indexed rentals – Renting assets and adjustments for inflation on similar property are considered to be clearly and closely related. Thus, unless a significant leverage factor is involved, an inflation-related derivative embedded in an inflation-indexed lease contract should not be separated from the host contract and separately evaluated as a potential variable interest.
Evaluation of variability and identifying variable interests

- Term-extending options – An option that allows either the lessee or lessor to extend the term of the lease at a fixed rate is not clearly and closely economically related to changes in the value of the leased asset and is a variable interest. However, options to extend the lease term at the current market rate for the asset are clearly and closely economically related.

- Contingent rentals based on lessee sales – Lease contracts that include contingent rentals based on certain sales of the lessee generally would be clearly and closely related to the value of the leased asset.

- Contingent rentals based on a variable interest rate – The obligation to make future payments for the use of leased assets and the adjustment of those payments to reflect changes in a variable market interest rate index (e.g., prime or LIBOR) generally would be considered clearly and closely related.

- Residual value guarantees – These guarantees obligate the lessee to make a payment to the lessor if the value of the leased asset is below a pre-determined amount at a future date. Because residual value guarantees are commonly used to transfer substantial risk of decreases in values of assets from a lessor to a lessee in a manner similar to a purchased put, they should be considered variable interests.

- Purchase options – These options give the lessee a right to acquire the leased asset from the lessor at a future date. Because fixed-price purchase options are commonly used to transfer the right to receive appreciation in values of leased assets from a lessor to a lessee in a manner similar to a written call, they should be considered variable interests. However, options allowing the lessee to acquire the leased asset at the asset's fair value at the date the option is exercised are not variable interests.

**Question 5.2** Should an interest rate swap with a notional amount that is less than half of the fair value of the VIE’s assets be accounted for as a variable interest in specified assets of the VIE?

Amounts owed pursuant to interest rate swap contracts are usually general obligations of a reporting entity, and payments made to the derivative counterparty typically do not depend on the cash flows of specific assets of the VIE. An interest rate swap that is a general obligation of a reporting entity should be evaluated to determine whether it is a variable interest in the VIE, regardless of whether it has a notional amount that is less than half of the fair value of a VIE’s assets.

**Question 5.3** Is a variable-rate liability owed to a VIE a variable interest in the entity?

A variable-rate liability owed to a VIE (e.g., a note receivable recognized as an asset on the balance sheet of the VIE) will have cash flows that vary based on changes in the market index upon which the floating interest payments are determined. A variable-rate liability owed to a VIE can be viewed as comprising two instruments – a fixed-rate instrument and an interest rate swap that transfers risk associated with changes in the fair value of the instrument due to changes in market rates from the VIE to the obligor. Because the obligor has assumed the risk of changes in fair value of the instrument through the embedded interest rate swap, it could be argued that the debtor has a variable interest in the entity in certain cases. However, ASC 810-10-55-31 specifies that "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." We generally believe that interest rate swaps embedded in debt instruments owed to a VIE are clearly and closely related economically to the host debt instrument and should therefore not be bifurcated from the host. Accordingly, variable-rate liabilities owed to a VIE generally are not variable interests in the entity.
5.4.5 Financial guarantees, written puts and similar obligations

Excerpt from Accounting Standards Codification

**Consolidation – Overall**

*Implementation Guidance and Illustrations – Variable Interest Entities*

**810-10-55-25**

Guarantees of the value of the assets or liabilities of a VIE, written put options on the assets of the VIE, or similar obligations such as some liquidity commitments or 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. To the extent the counterparties of guarantees, written put options, or similar arrangements will be called on to perform in the event expected losses occur, those arrangements are variable interests, including fees or premiums to be paid to those counterparties. The size of the premium or fee required by the counterparty to such an arrangement is one indication of the amount of risk expected to be absorbed by that counterparty.

**810-10-55-26**

If the VIE is the writer of a guarantee, written put option, or similar arrangement, the items usually would create variability. Thus, those items usually will not be a variable interest of the VIE (but may be a variable interest in the counterparty).

We believe a financial guarantee should be analyzed first to determine whether it is a variable interest in the entity as a whole or whether it is a variable interest in specified assets (See Section 5.5 for guidance on variable interests in specified assets).

While a determination must be made of the nature of the risks in the entity, the purpose for which the entity was created and the variability the entity was designed to create and distribute, we generally believe a third-party financial guarantee, by design, absorbs the credit risk associated with the possible default on the entity's assets or liabilities.

Accordingly, we generally believe the financial guarantor's credit risk is not a risk that the VIE was designed to create and distribute to the entity's variable interest holders. That is, we generally believe the financial guarantee would, by design, absorb the credit risk of the entity's assets or liabilities, and consequently, the financial guarantor would have a variable interest in the entity.

**Illustration 5-9: Financial guarantees**

An entity holds a portfolio of fixed-rate BBB-rated bonds, which it acquired in the market by issuing debt to unrelated investors. The bonds will be held to their maturities. The entity obtains a financial guarantee from ABC Co., which guarantees the timely collection of principal and interest payments due on the bonds. ABC Co.'s credit rating is AAA. The entity markets the debt as an investment in AAA-rated securities.

**Analysis**

The entity has (1) credit risk from the BBB-rated bonds, (2) fair value interest rate risk related to the BBB-rated bonds' periodic interest payments and (3) credit risk related to the AAA-rated financial guarantor.

We generally do not believe that variability arising from the periodic interest payments on the fixed rate bonds would be considered in applying the provisions of the Variable Interest Model because the bonds are to be held to their maturities, and the entity was not designed to create and distribute fair value variability to the individual debt holders.
While the entity was marketed to the investors as an investment in AAA-rated bonds, we believe that, by design, the entity was designed to create and distribute the risk related to the BBB-rated bonds, which is absorbed by ABC Co., through its financial guarantee. Because ABC Co.’s interest is considered to be an interest in the entity as a whole pursuant to ASC 810-10-25-55, ABC Co. has a variable interest in the entity.

In some cases, the reporting entity that receives the proceeds from the borrowing issues the guarantee. In those cases, we generally do not believe the reporting entity has a variable interest because it is, in effect, guaranteeing its own performance.

Illustration 5-10: Financial guarantees

Company A establishes a trust that issues debt to unrelated third parties and, in turn, loans the funds to Company A. The terms of the debt owed by Company A mirror those of the trust to its creditors. Company A also separately guarantees the trust’s debt.

Analysis

We believe the trust was designed to create and distribute Company A’s credit risk to the trust’s debt holders. Accordingly, Company A does not have a variable interest in the entity. In effect, Company A’s guarantee of the trust’s debt is a guarantee of its own performance because the trust’s only asset is a receivable from Company A.

5.4.6 Purchase and supply contracts

Purchase and supply contracts should be evaluated as potential variable interests in a manner similar to other forward contracts. If the contract is a derivative instrument, the contract should be evaluated in accordance with ASC 810-10-25-35 and 25-36. See Section 5.4.4.2 for further guidance.

We believe the risks the entity was designed to create and distribute and the terms of the supply contract should be considered to determine whether the contract is a variable interest. First, we believe a supply contract’s terms should be evaluated to determine whether they are at-market or contain embedded subordinated financial support. A contract’s off-market terms may provide financing or other support to an entity, which generally leads to a conclusion that the contract is a variable interest.

We believe that after determining whether a purchase or supply contract has embedded financing, its terms should be evaluated to determine whether it creates or absorbs variability. In making this decision, the volume of items purchased or supplied in the contract should be compared with the volume of items purchased or supplied by the entity. The lower the volume relative to the entity, the less likely it is that the contract would create or absorb variability. The higher the volume relative to the entity, the more likely it is by design that the contract would create or absorb variability. Other factors, such as pricing in the of the contract, also need to be considered when evaluating the purchase or supply contract.

The following chart – which is consistent with the guidance in Section 5.4.4.1 – also may be used as a general guide in making this determination.

<table>
<thead>
<tr>
<th>Contract pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Variable interest absorbs entity’s variability</strong></td>
</tr>
<tr>
<td><strong>Not a variable interest; creates entity’s variability</strong></td>
</tr>
<tr>
<td><strong>Not a variable interest because there is no variability</strong></td>
</tr>
</tbody>
</table>

10 Except when the supply contract is a derivative instrument that is determined not to be a variable interest in accordance with ASC 810-10-25-35 through 25-36.
Determining whether a purchase or supply contract is a variable interest should be based on careful consideration of all facts and circumstances and requires the use of professional judgment.

### 5.4.7 Operating leases

#### Excerpt from Accounting Standards Codification

**Consolidation — Overall**

**Implementation Guidance and Illustrations — Variable Interest Entities**

**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.

ASC 810-10-55-39 states that “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 the portion of the asset’s life that is covered by the lease. Most operating leases do not absorb variability in the fair value of the entity’s net assets because they are a component of that variability.” Therefore, we believe that operating leases with lease terms that are consistent with market terms at the inception of the lease and that do not otherwise include provisions such as a residual value guarantee, fixed-price purchase option or similar features are not variable interests in the lessor entity. Rather, they introduce variability into the lessor entity that is absorbed or received by the entity’s variable interest holders.

ASC 810-10-55-39 also states that “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.” We believe that if an operating lease has a residual value guarantee, fixed-price purchase option or similar feature, only the variability absorbed by that feature should be used in applying the provisions of the Variable Interest Model (i.e., while the operating lease is a variable interest in the lessor entity, the variability absorbed by the lessee through its lease payments should not be evaluated).

While not explicitly addressed in the Variable Interest Model, we believe that a lessor entity has a variable interest in the entity to which it leases an asset (for both operating and capital leases). We believe that the lease interest is analogous to a debt interest, or a financing arrangement.

#### 5.4.7.1 Private company accounting alternative

Private Companies can choose to be exempt from applying the Variable Interest Model to lessors in common control leasing arrangements that meet certain criteria. A private company is any entity that is not a public business entity, a not-for-profit entity or an employment benefit plan within the scope of ASC 960 through 965 on plan accounting. See Section 4.4.5 and Appendix D for further information.

#### 5.4.8 Lease prepayments

We believe lease prepayments to a lessor VIE are in substance a loan to the entity that will be repaid through the use of the leased asset(s). Because a loan to a VIE is generally a variable interest in the entity, prepayments of rent should be considered a variable interest.
5.4.9 Local marketing agreements and joint service agreements in the broadcasting industry

Local marketing agreements (LMAs) and joint service agreements (JSAs) are used regularly in the broadcasting industry to enable reporting entities to achieve economies of scale by combining the operations of stations in certain markets where FCC regulations would otherwise prohibit an acquisition. Because FCC licenses and the related broadcasting assets generally are held in a separate entity, the provisions of the Variable Interest Model generally are applicable to arrangements relating to the stations.

5.4.9.1 Local marketing agreements

Although LMAs may take many forms, a reporting entity generally will obtain the right to operate the broadcast assets of a station. The licensee (operator) will operate the station as a leased asset, making all programming and employment decisions, selling advertising and controlling substantially all operating cash inflows and outflows, subject to FCC-mandated limitations. Generally, reporting entities operating a station under an LMA pay a fixed monthly fee to the licensor (seller).

LMAs commonly are entered into because:

- Station owners may realize the efficiencies of operating multiple stations in a single market without actually acquiring additional broadcast licenses.
- FCC approval of the sale of the broadcast license is pending. The pending sale of a broadcast license is public information, which may lead to decreased ratings, advertising sales and the loss of employees before the acquirer assumes control of the station. LMAs allow the buyer to begin operating the station before approval of the license transfer, thereby minimizing some potential negative economic effects.

Under the terms of an LMA, the licensor and operator both maintain responsibility for the compliance of the station's programming with FCC rules and regulations, among other requirements. Accordingly, an LMA must give the licensor (1) the ability to terminate the agreement or (2) veto power over programming that it believes would not comply with FCC standards.

We believe that an LMA may represent a variable interest in the entity that owns the station assets. To make this determination, we believe the terms of the LMA should be evaluated to determine whether the agreement is analogous to the lease of property, plant and equipment subject to the provisions of ASC 840.

While ASC 840 specifically excludes intangible assets from its scope, we believe that the operator of an LMA should determine whether, by analogy to ASC 840, the arrangement is similar to an operating lease for the use of property, plant and equipment.

As discussed in Section 5.4.7, operating leases with lease terms that are consistent with market terms at the inception of the lease and do not include a residual value guarantee, fixed-price purchase option or similar feature generally will not represent a variable interest in an entity. Accordingly, if a reporting entity is operating a broadcast station under an LMA that is analogous to an operating lease, we believe the LMA generally would not be a variable interest in the entity holding the license and related broadcasting assets. Conversely, if an LMA is determined not to be analogous to an operating lease, generally we believe the contract represents a variable interest, and the provisions of the Variable Interest Model should be applied accordingly.
5.4.9.2 Joint service agreements

Generally, under a JSA, a reporting entity that owns a station in a given market will act as a service provider to a reporting entity that owns the FCC license and related station, tower and broadcasting equipment of a second station in the same market, combining the stations’ selling, marketing and bookkeeping functions. The reporting entities each retain ownership of their respective assets. The reporting entity acting as the service provider is responsible for the sale of advertising for both stations, administrative, operational and business functions, maintenance, repair and replacement of equipment and facilities. The service provider generally is required to obtain the second reporting entity’s approval of annual budgets and any capital expenditures.

The reporting entity acting as the service provider retains control over the programming and all other operations of the station it owns. It also consults with the second reporting entity about the programming that is aired on the second station, but that reporting entity, as the FCC license holder, retains the exclusive control over the programming, as well as employment decisions and financing of the second station. The reporting entity acting as the service provider collects and retains the operating revenues of both stations and remits a portion of the second station’s cash flows to the second reporting entity.

It is important to understand and evaluate all of the terms of a JSA before applying the provisions of the Variable Interest Model, including determining whether the arrangement is a variable interest in the entity that owns the broadcast station. Under ASC 810-10-55-37, fees paid to an entity’s decision maker(s) or service provider(s) are not a variable interest if certain conditions are met. See Section 5.4.13 for discussion of those conditions.

LMAs and JSAs may contain provisions (or may be entered into in conjunction with other agreements) for certain put or call options on the station’s assets at a future date. Additionally, other contractual provisions may provide protection against a decrease in the fair value of the station assets (e.g., a nonrefundable deposit received by the station owner that may be applied against the exercise price of a call option, if and when exercised, by the option purchaser). These terms should be evaluated carefully against the provisions of the Variable Interest Model because (1) the entity owning the station may be a VIE, and (2) the operator or service provider may be that entity’s primary beneficiary.

5.4.10 Purchase and sale contracts for real estate

When evaluating whether a purchase and sale contract for real estate is a variable interest, we believe that the design of an entity holding real estate should be carefully considered. However, generally we do not believe the Variable Interest Model’s provisions were designed to require purchasers of real estate to consolidate the entities holding that real estate upon entering a “typical” purchase and sale contract, effectively overriding ASC 976 and ASC 360-20’s provisions. We generally do not believe that a “typical” purchase and sale contract for real estate that provides for conditions prior to closing is a variable interest because (1) ASC 360-20-40-5 provides that, among other conditions, profit on real estate transactions is not to be recognized until a sale has been consummated, and (2) by design, a purchase and sale contract does not transfer to the buyer the usual benefits of ownership of the real estate. Therefore, the purchase and sale contract generally will not cause the purchaser to consolidate the entity holding the real estate.

We believe a real estate purchase and sale contract’s terms should be evaluated to determine, based upon all facts and circumstances, whether the purchaser has a substantive right to terminate the contract and receive the return of its escrow deposit. If the purchaser’s rights to terminate the contract and to receive its deposit are substantive, generally we believe the purchase and sale contract is not a variable interest.
We believe the following conditions, among others, should be considered in determining whether the conditions prior to the purchaser’s obligation to close are substantive:

- Must the existing lender consent to the transfer of the property and the assumption of the existing loan? Has that consent been obtained?
- Do title requirements exist that the seller is required to comply with?
- Are there any specified violations that must be cured prior to the closing date? What is the nature of those violations?
- Is the seller required to obtain estoppel certificates?
- Is the contract terminable upon the event of a material casualty to the property prior to closing? Who bears the risk of loss on the property?
- What are the seller’s representations and warranties? For example, could the termination of a tenant lease or a material default by a tenant permit the purchaser to terminate the contract and receive a refund of the escrow deposit?

However, if a purchase and sale contract, by design, provides the purchaser with no rights or non-substantive rights to terminate the contract and has passed the risks and rewards of the real estate to the purchaser, the contract would be a variable interest in the entity.

Additionally, we generally believe a lot option contract to control a supply of land to be used in future construction by homebuilders is subject to the Variable Interest Model’s provisions.

### 5.4.11 Netting or offsetting contracts

We generally believe the application of the Variable Interest Model requires each instrument or contract to be identified as either a creator or absorber of variability based on the role of that instrument and the risk the entity was designed to create and distribute to its interest holders. While applying the provisions of the Variable Interest Model may result in the variability of instruments offsetting each other because they are both deemed to be creators of variability, it is not appropriate for the reporting entity or the entity to net contracts and conclude that the entity was not designed to create and distribute the underlying risk.

To illustrate, assume an entity holds a portfolio of financial assets, which was funded by issuing senior debt, subordinated debt and equity. It would not be appropriate to net the credit risk absorbed by the subordinated debt and equity against the assets and conclude that the risk the entity was designed to create and distribute is the credit risk to be absorbed by the senior debt holder.

Similarly, in applying the provisions of the Variable Interest Model, we generally do not believe it is appropriate to net or offset synthetic positions. For example, if the entity above purchased credit protection through either a guarantee or credit default swap, the risk absorbed by the guarantor or the writer of the credit default swap cannot be netted against the credit risk in the assets. Instead, each contract should be evaluated as a potential absorber of the entity’s designed variability (considering ASC 810-10-25-35 and 25-36).

However, in certain circumstances the entity’s design may lead to a conclusion that an instrument should be netted in applying the provisions of the Variable Interest Model.
Illustration 5-11: Netting or offsetting contracts

Bank A, seeking to obtain protection for Investment Y, enters into a credit default swap with a newly established trust. Investors purchase credit-linked notes (CLN), the proceeds from which are invested in US Treasury securities. Bank A pays a specified premium for credit protection, and if a credit event (as defined) occurs, the trust pays Bank A the notional amount and receives Investment Y. The credit-linked notes are satisfied through delivery of the defaulted bonds or by selling them and paying cash.

Bank A also contributes cash to the entity in exchange for equity. That equity investment absorbs the first dollar risk of loss created by the credit default swap.

The arrangement is depicted as follows:

Analysis

We believe the trust was designed to create and distribute the credit risk of Investment Y. Accordingly, the credit default swap issued to Bank A would be a creator of variability. The credit-linked notes are variable interests because they absorb the risk the entity was designed to create and distribute, the credit of Investment Y.

We do not believe Bank A’s equity investment is a variable interest because, by design, Bank A absorbs losses that it created through its credit default swap. That is, on a net basis – by design – Bank A has no risk for this equity investment. Any loss absorbed by Bank A in its equity is, by design, equal to its gain on the credit default swap, leaving it neutral to the credit risk of Investment Y for the amount of the equity investment.

Economically, we believe Bank A effectively has created a deductible to its credit protection. That is, Bank A effectively has obtained an “insurance policy” from the credit-linked note holders, and that “policy” provides protection for losses only in excess of Bank A’s equity investment.

We believe Bank A could have structured the transaction similarly by having the credit default swap’s terms state that Bank A was entitled to payment only after losses exceeded a deductible amount. Under either alternative, we believe the accounting should be the same; the trust was designed to create and distribute credit risk that is absorbed only by the credit-linked note holders.

The basic terms of this structure may be used in different arrangements including financial guarantees and insurance/reinsurance. We believe there may be other views in the accounting for these arrangements. Accordingly, readers are cautioned to carefully evaluate the structure’s design considering all of the individual facts and circumstances in applying the provisions of the Variable Interest Model.
5.4.12 Implicit variable interests

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Recognition — Variable Interest Entities**

**Consolidation Based on Variable Interests — Implicit Variable Interests**

**810-10-25-49**

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.

**810-10-25-50**

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.

**810-10-25-51**

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.

**810-10-25-52**

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.

**810-10-25-53**

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.
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 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.

ASC 810-10-55-25 states that “guarantees of the value of the assets or liabilities of a VIE … (explicit or implicit) … are variable interests if they protect holders of other interests from suffering losses.” Although ASC 810-10-55-25 refers to guarantees as one type of implicit variable interest, there are other types.

Implicit variable interests should be considered in applying all of the provisions of the Variable Interest Model. Implicit variable interests may cause an entity to be a VIE (e.g., an implicit variable interest could protect the holders of the entity’s equity investment at risk).

Implicit variable interests are the same as explicit variable interests in that they both absorb the entity’s variability. However, implicit variable interests indirectly (as opposed to directly) absorb the entity’s variability. These interests may arise from transactions with both related and unrelated parties. While the determination of whether an implicit variable interest exists is based on the facts and circumstances, transactions in which (1) the reporting entity has an explicit variable interest in, or other involvement with, an entity and (2) a related party has a variable interest in the same entity, should be closely examined to determine whether there are any implicit variable interests.

The following factors should be considered in determining whether the reporting entity has an implicit variable interest in an entity involving related parties:

> What is the nature of the related party relationship? An implicit variable interest may exist when a related party has the ability to control or significantly influence the reporting entity. For example, assume the chief executive officer (CEO) of a reporting entity is also the CEO and sole owner of an entity that provides services to the reporting entity. The nature of the related party relationship may indicate that the CEO may require the reporting entity to reimburse the entity for losses incurred (losses that otherwise would be absorbed by the CEO).

> What is the economic impact, if any, to the reporting entity or related party? For example, if the reporting entity and related party were wholly owned subsidiaries of the same parent, there would be no net economic benefit to the parent from the implicit guarantee. However, an economic incentive may exist if the reporting entity was not wholly owned and a portion of the losses, for example, on a guarantee, could be allocated to the reporting entity’s noncontrolling owners.
Evaluation of variability and identifying variable interests

Financial reporting developments

Consolidation and the Variable Interest Model | 93

Under what constraints do the reporting entity and related party operate? Are all related party transactions separately evaluated by senior management? Is the reporting entity or related party subject to regulation?

Do other parties involved with the reporting entity or the related party believe implicit variable interests exist? For example, in setting the interest rate on the reporting entity’s newly issued debt, did the financial institution believe there were any guarantees or other forms of credit support that were not reflected in the reporting entity’s financial statements?

Implicit variable interests may also arise when a reporting entity, by design, enters into contracts with variable interest holders outside the entity that effectively protect those holders from absorbing a significant amount of the entity’s variability. Factors that should be considered in determining whether the reporting entity has an implicit variable interest in entities include:

- 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?

The determination of whether an implicit variable interest exists is based on facts and circumstances, requiring the use of professional judgment.

The following example, has been adapted from an example, originally issued in FASB Staff Position FIN46(R)-5: Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003) illustrates implicit variable interests. In practice, this example was often considered when evaluating whether an implicit interest exists. In conjunction with the issuance of ASU 2014-07, the FASB removed the example from the Codification due to concerns that this guidance might cause confusion regarding whether lessees could be required to apply the Variable Interest Model when they may qualify for an exemption from applying it under the private company alternative discussed in Appendix D. We do not believe that the FASB intended the elimination of this guidance to have a significant effect on current practice for those not adopting the alternative. That is, a reporting entity that applies the Variable Interest Model should evaluate whether it has an implicit variable interest in an entity and if so, then determine whether it is the primary beneficiary. We believe the example still provides practical guidance when evaluating implicit variable interests.

**Illustration 5-12: Implicit interests**

One of the two owners of Manufacturing Entity is also the sole owner of Leasing Entity, which is a VIE. The owner of Leasing Entity provides a guarantee of Leasing Entity’s debt as required by the lender. Leasing Entity owns no assets other than the manufacturing facility it leases to Manufacturing Entity. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest. The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Entity and Leasing Entity.
Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity. Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity because of the leasing arrangement and the relationship between it and the owner of Leasing Entity. For example, Manufacturing Entity would hold an implicit variable interest in Leasing Entity if Manufacturing Entity effectively guaranteed the owner’s investment in Leasing Entity.

Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent the owner’s guarantee of Leasing Entity’s debt from being called on, or Manufacturing Entity may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Entity’s debt if the guarantee is called. The determination of whether Manufacturing Entity is effectively guaranteeing all or a portion of the owner’s investment or would be expected to make funds available and, therefore, an implicit variable interest exists, takes into consideration all the relevant facts and circumstances. Those facts and circumstances include, but are not limited to, whether (1) there is an economic incentive for Manufacturing Entity to act as a guarantor or to make funds available, (2) such actions have happened in similar situations in the past, and (3) Manufacturing Entity acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

### 5.4.13 Fees paid to decision makers or service providers

**Excerpt from Accounting Standards Codification**

**Consolidation – Overall**

**Implementation Guidance and Illustrations – Variable Interest Entities**

**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.

**810-10-55-38**

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 Variable Interest Model provides separate guidance for determining whether fees paid to an entity’s decision makers or service providers represent variable interests in the entity. Examples of decision makers or service providers that should evaluate their fee arrangements under this guidance include asset managers, real estate property managers, oil and gas operators, and providers of outsourced research and development.
Three conditions must all be met to conclude that fees received by an entity’s decision makers or service providers do not represent variable interests in that entity:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The service arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated at arm’s-length.
- The decision maker or service provider (and its related parties or de facto agents) 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.

Fee arrangements that expose a reporting entity to risk of loss are considered variable interests and are not evaluated using these conditions. See Section 5.4.13.3 for guidance.

The guidance is intended to allow a decision maker or service provider to determine whether it is acting as a fiduciary or an agent rather than as a principal. If a decision maker or service provider meets all three conditions, it is acting as an agent. If a decision maker or service provider concludes that it does not have a variable interest in an entity after evaluating these conditions and considering any other interests in the entity, we believe that the decision maker or service provider is not required to evaluate the provisions of the Variable Interest Model further. This includes determining whether the decision maker or service provider is the primary beneficiary of the entity and whether the decision maker or service provider is subject to the disclosure provisions of the Variable Interest Model.

If, however, a decision maker or service provider fails to meet any of the three conditions, the fee would be deemed a variable interest and the decision maker or service provider may need to consolidate the entity. A service contract that represents a variable interest and conveys the ability to make decisions may cause the decision maker or service provider to be the primary beneficiary of the VIE.

A decision maker’s or service provider’s evaluation of whether a fee arrangement is a variable interest will require a careful examination of the facts and circumstances and the use of professional judgment.

**Question 5.4**

If the fees are not a variable interest, is the decision maker or service provider required to evaluate whether the power held through its fee arrangement may cause it to be the primary beneficiary or consider the disclosure requirements of the Variable Interest Model? (Updated February 2016)

ASC 810-10-25-38 states, “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 [emphasis added] on the basis of the provisions in paragraphs 810-10-25-38A through 25-38J.” Therefore, we do not believe that the “power” criterion could be met through an interest that is not a variable interest.

If a decision maker or service provider concludes that its fee arrangement is not a variable interest in an entity after evaluating the provisions of ASC 810-10-55-37 and considering any other interests in the entity, we believe that the decision maker or service provider is not required to evaluate the provisions of the Variable Interest Model further to account for its fee. This includes determining whether the decision maker or service provider is the primary beneficiary of the entity and whether the decision maker or service provider is subject to the disclosure provisions of the Variable Interest Model with respect to its fee. We believe this is consistent with the FASB’s view in paragraph BC76 of the Basis for Conclusions to
ASU 2015-02. The SEC staff also expressed a view in a December 2015 speech that once a manager determines that it does not have a variable interest, it would not be required to consolidate the entity as a result of applying the related party tiebreaker test.

However, if the decision maker or service provider has other interests in an entity, the decision maker or service provider should consider the disclosure requirements under the Variable Interest Model with respect to its other interests.

Illustration 5-13: Fee arrangement and a significant equity interest

A general partner (GP) receives a fee for managing a partnership. The GP determines that the fee arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services, and the fee is commensurate with the level of effort required to provide those services. The GP also holds a 20% equity interest in the partnership.

Analysis

The fee does not meet all three conditions in ASC 810-10-55-37 because the GP also holds a significant equity interest in the partnership (i.e., the fee fails condition (c)). Therefore, the fee is a variable interest, in addition to the GP's equity interest in the partnership. The GP would be required to evaluate the provisions of the Variable Interest Model further (i.e., determining whether the partnership is a VIE and if so, whether the GP is the primary beneficiary). In addition, the GP would be subject to the disclosure provisions of the Variable Interest Model.

Illustration 5-14: Fee-arrangement and a de minimis equity interest

A manager receives a fee for managing a mutual fund, which is calculated as a percentage of the net assets it manages. The manager determines that the fee arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services, and the fee is commensurate with the level of effort required to provide those services. The manager also holds a de minimis equity interest in the fund. The manager does not have any related parties that hold equity interests in the fund.

Analysis

The fee meets the three conditions in ASC 810-10-55-37 and therefore does not represent a variable interest in the fund.

However, the manager would be required to evaluate the provisions of the Variable Interest Model further with respect to its de minimis equity interest in the fund.

Illustration 5-15: Collateralized loan obligation

A manager of a collateralized loan obligation (CLO) structure receives a fee for the services it provides. The fee is deemed to be commensurate with the services provided and to include only terms and conditions that are customarily present in similar arrangements. Further, the fee is subordinate to senior debt and other operating payables, but it is insignificant relative to the entity's economic performance and does not absorb more than an insignificant amount of the entity's economic performance. The manager, its related parties and de facto agents do not hold any other interests in the CLO.

---

Analysis

The fee meets the three conditions in ASC 810-10-55-37 and therefore does not represent a variable interest in the CLO. The manager is not required to evaluate the provisions of the Variable Interest Model further (i.e., determining whether the entity is a VIE and if so, whether the manager is the primary beneficiary). The manager is not subject to the disclosure provisions of the Variable Interest Model.

5.4.13.1 Conditions (a) and (d): Fees are commensurate with the level of effort required and include only customary terms and conditions (Updated February 2016)

Excerpt from Accounting Standards Codification
Consolidation — Overall
Implementation Guidance and Illustrations — Variable Interest Entities
810-10-55-37B
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.

For fees not to be considered a variable interest, a decision maker or service provider should carefully evaluate whether the fees received are commensurate with the level of effort required to provide those services (i.e., at market), and whether the fees include only customary provisions, which may indicate the decision maker or service provider is not acting as an agent.

To assess whether the fees meet these conditions, a decision maker or service provider may need to compare the fee arrangement to similar arrangements. For example, it may be common for servicers to earn fixed fees of 50 basis points on the assets they service but uncommon to earn 5% incentive fees on those same assets. The more common a fee structure is, the more likely it is that the fee would meet these conditions, and the less evidence that may be required to determine that these conditions are met. However, a fee would not presumptively fail these conditions if the fee arrangement was unique such that comparable service arrangements are not readily observable.

We believe that an evaluation of what is commensurate and customary will require a careful evaluation of the purpose and design of each entity and will require professional judgment. Given variations in structures and arrangements across industries, there are no bright lines for determining what is commensurate or customary. When making this determination, consideration also should be given to typical characteristics of arrangements for providing services, the timing of when the fee is earned and paid, the form of the consideration, the manner in which the fees are computed (e.g., fixed fees, performance-based fees) and the cancellation provisions of the agreement.

For example, consider an agreement in which the decision maker or service provider could not be removed as long as the entity had a specific bank loan outstanding from an unrelated third party. If the decision maker or service provider concluded that was not a customary cancellation provision of a decision-making agreement, that provision may indicate that the fee is a variable interest, even if the amount received was otherwise commensurate and customary.
Question 5.5  
Can a fee be presumed to be commensurate and customary simply because unrelated parties have agreed to the terms of the fee? (Updated February 2016)

There is no presumption in ASC 810-10-55-37B that just because unrelated parties have agreed to the terms of the fee, it can be presumed to be commensurate and customary. The presence of unrelated investors may be helpful in performing this evaluation, but is not determinative; all facts and circumstances should be considered. Determining whether a fee is commensurate and customary requires the use of professional judgment.

In addition, the SEC staff expressed a view in a December 2015 speech\(^\text{12}\) that determining whether fees are commensurate often can be accomplished with a qualitative evaluation of whether an arrangement was negotiated on an arm’s-length basis when the decision maker had no obligations other than to provide the services to the entity being evaluated for consolidation. The SEC staff cautioned that this analysis requires a careful consideration of the services to be provided in relation to the fees.

On the evaluation of whether terms, conditions and amounts included in an arrangement are customary, the SEC staff said that this may be accomplished in ways such as benchmarking the key characteristics of the 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. The SEC staff emphasized that there are no bright lines in evaluating whether an arrangement is customary, and reasonable judgment is required in such an evaluation.

Question 5.6  
Does the size of a fee affect whether it is a variable interest?

ASU 2015-02 removed the following criteria from the determination of whether a fee is a variable interest:

- The total amount of anticipated fees is insignificant relative to the total amount of the VIE’s anticipated economic performance.
- The anticipated fees are expected to absorb an insignificant amount of the variability associated with the VIE’s anticipated economic performance.

The FASB decided that a reporting entity need not focus on the magnitude and variability of the fee when evaluating whether a fee or service arrangement is a variable interest because it concluded that the remaining conditions are sufficient for determining whether a reporting entity is acting as an agent.

However, the magnitude of a fee in comparison to other arrangements for similar services should be carefully considered when evaluating whether the fee is commensurate with the services provided and includes only customary terms and conditions. That is, the size of the fee in comparison to other arrangements and expectations may be relevant in determining whether those conditions are met.

5.4.13.2 Condition (c): Other interests held by a decision maker or service provider

Excerpt from Accounting Standards Codification

Consolidation – Overall

Implementation Guidance and Illustrations – Variable Interest Entities

810-10-55-37D

... 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.

When determining whether fees paid to a decision maker or service provider are a variable interest, ASC 810-10-55-37(c) indicates that the decision maker or service provider cannot hold other interests that would absorb “more than an insignificant amount” of the entity's expected losses or residual returns. This threshold is used to evaluate the magnitude of the other interest(s) held by an entity's decision maker or service provider. The FASB has not provided any detailed implementation guidance or bright-line rule for considering the quantitative threshold contained in this condition.

We believe the provisions of ASC 810-10-55-37 are based upon the FASB's objective of having a reporting entity determine whether it is acting as a fiduciary (or agent) or a principal in its role as a decision maker or service provider. The FASB believes that the larger the other variable interest(s) held by the decision maker or service provider become, the more likely it is that the decision maker or service provider is acting as a principal. Therefore, the FASB provided the threshold of “more than an insignificant amount” for making this assessment. We believe that “more than insignificant” should be interpreted to mean the same as “significant.”

We also believe that an evaluation of the threshold of more than insignificant will require a careful evaluation of the purpose and design of the entity and will require significant professional judgment. In addition, qualitative factors may be relevant in making this determination, such as the nature of the other variable interests held (e.g., senior versus subordinated interests) rather than the pure magnitude of those interests.

The following are some additional considerations:

- We believe that a decision maker or service provider may determine that it can hold a higher dollar amount of senior interests than it could if the interests held were subordinated or residual interests and still not meet the “more than an insignificant amount” threshold. That is, if the senior interest is not expected to absorb a significant amount of expected losses or expected residual returns, a relatively large senior interest (as compared with a residual ownership interest) may not necessarily cause the decision maker's or service provider's fees to be considered a variable interest.

- It may be relevant to compare the significance of the interests held by a decision maker or service provider in an entity to the typical interests held by other decision makers or service providers in other similar entities. If the decision maker's or service provider's other interests are significantly higher than those of others providing similar services to similar entities, the decision maker's or service provider's interests are more likely to be viewed as significant.

- In assessing significance under ASC 810-10-55-37, the quantitative approach described in the definitions of the terms “expected losses,” “expected residual returns” and “expected variability” in the ASC Master Glossary is not required and should not be the sole determinant.

- Because ASC 810-10-55-37 refers to interests that would absorb expected losses or expected residual returns, we believe that decision makers and service providers will need to consider probability-weighted outcomes over the life of the entity, not current performance, economic conditions or what could potentially occur. This evaluation will require significant judgment.
Other interests could include implicit variable interests. See Section 5.4.12 for further discussion of implicit variable interests.

**Question 5.7** Is the concept of “insignificant” in the evaluation of whether a reporting entity’s fees represent a variable interest under ASC 810-10-55-37 the same as “could be potentially significant” in the determination of whether a reporting entity has benefits in the primary beneficiary assessment?

No. We believe that they are different thresholds. In ASC 810-10-55-37, we believe that the assessment of significance considers expected or probability-weighted outcomes. The FASB’s use of the phrase “would absorb” in ASC 810-10-55-37(c) implies that expected outcomes are the barometer by which the fees or other variable interests are measured.

In contrast, we believe that the assessment of significance as part of the primary beneficiary determination contemplates possible outcomes. In other words, we believe that a consideration of the likelihood or probability of the outcome generally is not relevant for the primary beneficiary assessment. The FASB’s use of the phrase “could potentially be significant” implies that the threshold is not “what would happen,” but “what could happen.” Accordingly, a reporting entity would meet the “benefits” criterion if it could absorb significant losses or benefits, even if the events that would lead to such losses or benefits are not expected.

**Question 5.8** How does an investor consider “seed money” when evaluating the significance of other interests?

A decision maker or service provider may invest “seed money” (i.e., an early stage investment in an entity to cover initial operating costs or entice other investors to invest in the entity) in exchange for receiving an ownership interest in the entity. Depending on the size of the initial investment relative to other investors, the seed money may be a significant interest upon the formation of the entity.

Although the decision maker or service provider may expect, based on the purpose and design of the entity, that its ownership interest will be diluted over time when others invest in the entity, such that its interests are expected to be nominal when the entity reaches maturity, we do not believe a decision maker or service provider should consider the possibility of dilution when initially evaluating whether its fee is a variable interest. That is, a decision maker or service provider should determine whether its fees are a variable interest based on the significance of other interests as of the date it first becomes involved with the entity. If such dilution occurs at a future date, that dilution may trigger a reconsideration event. Such reconsideration occurs at the date the funds raises additional capital from its investors, as discussed in Section 5.4.13.4.

As a result, it is possible that a decision maker or service provider may be the primary beneficiary of an entity at its inception and continuing for a period, and then deconsolidate the entity at a subsequent date when others invest in the entity (that is, upon the reconsideration event) such that the decision maker’s or service provider’s interest no longer absorbs more than an insignificant amount of variability. At that point, its fee relationship may no longer constitute a variable interest. However, the decision maker’s or service provider’s results of operations for the reporting period would reflect the consolidation of the entity for the period for which it was the primary beneficiary and consolidated the entity.

**Question 5.9** If a decision maker or service provider has an equity interest that is not significant enough to cause its fee to be a variable interest, can the equity interest still be a variable interest on its own?

Yes. A decision maker or service provider should still evaluate whether its other direct interests in the entity are variable interests, even if they are not significant enough to cause the fee to be a variable interest. Generally, equity investments are variable interests (see Section 5.4.1 for guidance).

However, if the decision maker or service provider has power over the entity through a management contract that is determined not to be a variable interest, that power would not be considered in the identification of the primary beneficiary.
5.4.13.2.1 Interests held by related parties when evaluating fees paid to a decision maker or service provider (Updated February 2016)

Excerpt from Accounting Standards Codification
Consolidation – Overall
Implementation Guidance and Illustrations – Variable Interest Entities
810-10-55-37D

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

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

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

When evaluating whether the fees paid to a decision maker or service provider are a variable interest, ASC 810-10-55-37D states that “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, interests held by entities under common control and its indirect economic interests in the entity held through related parties, considered on a proportionate basis.”

In paragraphs 65 and 66 of the Basis for Conclusions to ASU 2015-02:

“Under existing GAAP, Subtopic 810-10 requires interests held by a reporting entity’s related parties to be treated as though they belong to the reporting entity when evaluating whether the service arrangement is a variable interest and when determining whether a related party group has the characteristics of a primary beneficiary. In its deliberations leading up to the 2011 Exposure Draft, the Board decided that a decision maker should consider only its proportionate exposure through its interest in a related party and not the entire interest held by the related party...

---

13 Examples of entities under common control include a parent and its subsidiaries or two sister companies of a common parent or controlling shareholder. Determining whether entities are under common control will require judgment based on the facts and circumstances. See Appendix C of our FRD, Business combinations, for additional guidance on determining whether entities are under common control.
Many stakeholders questioned whether it always would be appropriate to consider a decision maker’s related party interests on a proportionate basis in the indirect assessment. Specifically, many noted that the evaluation should allow for judgment on a more qualitative basis rather than being strictly quantitative. For instance, there may be situations in which the decision maker exerts more control over the related party than the quantitative amount that its economic interest may indicate, such as when the related parties are under common control. In response to these concerns, the Board decided that related party interests should be considered on a proportionate basis, except when the related parties that have an indirect interest are under common control. In addition, employees’ interests should be considered in the indirect assessment to the extent that they are financed by the decision maker.

We believe that the following factors should be considered when determining whether to include the interests held by the related party:

- Purpose and design of the entity
- Nature of the interests held by the related party
- Variability absorbed by the related party
- Whether the related party was involved designing the entity and determining which rights were given to the decision maker or service provider (because this may indicate that the related party had an opportunity to separate the decision making from the economics of the entity)
- Whether the related party is under common control

ASC 810-10-55-37D introduces the concept of an “indirect” interest when evaluating interests held by related parties. Under ASC 810-10-55-37D, a decision maker or service provider will consider its direct interests, plus its proportionate share of a related party’s or de facto agent’s interests (i.e., indirect interests). To have an indirect interest, a decision maker or service provider must have a direct variable interest in a related party that has a variable interest in an entity. In addition, ASC 810-10-55-37D states, “indirect interests held through parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety.”

Questions have arisen about how a decision maker or service provider should apply this guidance when the decision maker or service provider does not have an ownership interest in a related party under common control that has an investment in the entity being evaluated for consolidation. The SEC staff stated in a December 2015 speech that a decision maker or service provider would not include such interests when considering significance, unless the structure was designed to avoid consolidation by the decision maker or service provider.

In the speech, the SEC staff highlighted an example in which an entity has four investors that are unrelated to one another and has a manager that is under common control with one of the investors. The manager does not have any interest in any of the investors or the entity. However, it has the power to direct the activities of the entity that most significantly impact its economic performance through its fee arrangement.

The staff said that in this example, if the manager’s fee would otherwise not meet the criteria to be considered a variable interest (i.e., it was customary and commensurate), the fact that an investor under common control with the manager has a variable interest in the entity would not by itself cause the

---

14 In this context, related parties include de facto agents of the reporting entity. See Chapter 10 for the Variable Interest Model’s definition of related parties and de facto agents.

15 See Section 2.7, for a summary on recent standard setting activity associated with potential changes to the indirect interests considerations in the VIE model.

manager’s fee to be considered a variable interest. However, the staff cautioned that when a controlling party in a common control group designs an entity to separate power from economics to avoid consolidation in the separate company financial statements of a decision maker, the SEC staff has viewed such separation to be non-substantive.

Additionally, the SEC staff concluded that once the manager determined that it does not have a variable interest in the entity, it would not be required to consolidate the entity as a result of applying the related party tiebreaker test.

**Illustration 5-16: Direct and indirect interests: related parties not under common control**

Entity A, the decision maker, has a 5% direct interest in and receives a management fee from a VIE it is evaluating for consolidation. Entity A has a 10% interest in a related party (Entity B) that owns a 20% interest in the VIE. The decision maker’s fee arrangement is commensurate with the effort required to provide the services and only includes customary terms. The decision maker and its related party are not under common control.

**Analysis**

We believe that the decision maker’s total other interests for determining whether its fee is a variable interest would be 7% (i.e., 5% + (10% x 20%)).

**Illustration 5-17: Direct and indirect interests: related parties not under common control with no indirect interest**

Assume the same facts as in Illustration 5-16, except that Entity A does not have a direct interest in Entity B.

**Analysis**

We believe that the decision maker’s total other interests for determining whether its fee is a variable interest would be 5%. The interest held by Entity B is not included since Entity A does not have a direct interest in Entity B.
Illustration 5-18: Direct and indirect interests: related parties under common control with indirect interest

Assume the same facts as in Illustration 5-16, except the decision maker (Entity A) and Entity B are under common control.

Analysis

We believe that the decision maker’s total other interests for determining whether its fee is a variable interest would be 25% (i.e., 5% + 20%). The decision maker determines that the entire interest held by Entity B is included since Entity A has a direct interest in Entity B and Entity A and Entity B are under common control.

Illustration 5-19: Direct and indirect interests: related parties under common control with no indirect interest

Assume the same facts as in Illustration 5-18, except that Entity A does not have a direct interest in Entity B.

Analysis

We believe that the decision maker’s total other interests for determining whether its fee is a variable interest would be 5%. The interest held by Entity B is not included since Entity A does not have a direct interest in Entity B.

5.4.13.2.2 Interests held by employees when evaluating fees paid to a decision maker or service provider

ASC 810-10-55-37D states that variable interests held by an employee or the employee benefit plan of a reporting entity, including those of its related parties and de facto agents, are not aggregated with that of the reporting entity, except if the employee or employee benefit plan is used in an effort to circumvent the provisions of the VIE model. The FASB believes that the term “employee benefit plan” would include defined contribution and defined benefit plans.
This evaluation differs from how interests held by employees are considered in the primary beneficiary analysis. As discussed in Section 9.2, when identifying the primary beneficiary of an entity, if an employee owns an interest in the entity being evaluated and that employee’s interest has been financed by the reporting entity, the reporting entity would include that financing as its indirect interest in the evaluation.

### 5.4.13.3 Fees that expose a reporting entity to risk of loss

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidation — Overall</strong></td>
</tr>
<tr>
<td><strong>Implementation Guidance and Illustrations — Variable Interest Entities</strong></td>
</tr>
<tr>
<td>810-10-55-37C</td>
</tr>
<tr>
<td>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:</td>
</tr>
<tr>
<td>a. Those related to guarantees of the value of the assets or liabilities of a VIE</td>
</tr>
<tr>
<td>b. Obligations to fund operating losses</td>
</tr>
<tr>
<td>c. Payments associated with written put options on the assets of the VIE</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

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 are not evaluated using the conditions in ASC 810-10-55-37. Rather, such fees or arrangements are variable interests.

Examples of fees that could expose a reporting entity to loss include fees related to the following:

- Guarantees
- Obligations to fund operating losses
- Payments associated with written put options on the assets of the VIE
- Liquidity commitments and similar obligations (explicit or implicit) that protect holders of other interests from suffering losses in the VIE

As discussed in paragraph 42 of the Basis for Conclusions to ASU 2015-02, fees for compensation for service arrangements that do not expose the decision maker or service provider to the risk of loss, but only to opportunity costs of the non-receipt of fees (e.g., performance based fees) and that meet the conditions in ASC 810-10-55-37 are not considered variable interests.

### 5.4.13.4 Reconsideration of a decision maker's or service provider's fees as variable interests

When a decision maker or service provider first becomes involved with an entity, it is required under the provisions of the Variable Interest Model to evaluate whether its fees represent variable interests. We believe the purpose of this evaluation is to determine whether the decision maker or service provider is acting as a principal or as an agent with respect to the entity. This evaluation considers the terms and conditions of the fee relationship. In addition, ASC 810-10-55-37(c) requires consideration of other
interests that a reporting entity may hold in determining whether the fees constitute variable interests. After the initial determination of whether the fees constitute variable interests, a reporting entity should assess whether events have occurred that would require a reconsideration of that determination.

In making the initial determination of whether a reporting entity holds a variable interest, we believe that it is important for a reporting entity to consider the purpose and design of the entity in evaluating the characteristics of the fee as well as the other interests held by the reporting entity. Therefore, we generally believe that changes to the purpose or design of the entity would require reconsideration of the fees as variable interests.

Also, we believe that substantive changes to a fee’s contractual terms may require a reporting entity to reevaluate whether its fees are variable interests. However, generally, we believe that absent a fundamental change in the fees’ contractual terms, it is unlikely that a reporting entity’s original determination of whether its fees are commensurate with the level of effort required and include only customary terms and conditions would change.

However, if the significance of a decision maker’s or service provider’s other interests changes (e.g., complete disposition or disposition of a substantive portion, acquisition of additional interests, dilution), we believe that a reporting entity should reevaluate ASC 810-10-55-37(c). Upon reconsideration, the reporting entity may conclude that the evaluation of the significance of the variability absorbed by those interests has changed.

We generally do not believe that a reporting entity should reevaluate whether its fees are variable interests simply because of a change in the economics of the entity driven by market conditions, entity-specific conditions or other factors. For example, a reporting entity that holds a residual interest in an entity would not reconsider whether its fees constitute variable interests simply because the reporting entity has written down its investment. We do not believe that it was the FASB’s intent for a decision maker or service provider to reevaluate its status as a principal or an agent when there have been changes to the entity’s economic performance. Otherwise, the fees could change to or from variable interests simply due to periodic market fluctuations. We believe that the rationale for this position is similar to that for reconsidering whether an entity is a VIE. The FASB concluded that the status of an entity as a VIE should be reconsidered only upon specified events, in part to avoid changes in the entity’s anticipated economic performance resulting in a change the entity’s status as a VIE (see Chapter 11 for guidance on reconsideration events).

However, there may be certain limited circumstances in which a reporting entity determines that its investment in an entity (through interests other than its fee) is “worthless.” For example, a reporting entity may conclude that there is only a de minimis potential for an investment (through interests other than its fee) to provide it with future cash flows. In this case, we believe the reporting entity may reconsider the provisions of ASC 810-10-55-37(c) and reconsider whether its fees are variable interests (i.e., whether the reporting entity is no longer a principal). In evaluating whether an investment is worthless, a reporting entity should carefully consider all facts and circumstances. One important element to consider may be whether there is a potential scenario (based on consideration of realistic assumptions) that the reporting entity will receive cash flows associated with its investment or otherwise receive some future return. Such a scenario may suggest that an investment is not worthless. We would expect that a reporting entity would develop a consistent policy and approach for determining whether an interest is considered to be worthless for the ASC 810-10-55-37 assessment. Additionally, we expect the scenarios in which an investment is deemed worthless will be infrequent.
Excerpt from Accounting Standards Codification
Consolidation — Overall

Recognition — Variable Interest Entities

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.

In some situations, a reporting entity holds a variable interest in only a specified asset or group of assets of an entity. This distinction is important because if a party has a variable interest in specified assets of a VIE but not in the VIE as a whole, it cannot be required to consolidate the VIE. If a reporting entity has a variable interest in the VIE as a whole, it is required to evaluate whether it is the primary beneficiary of the VIE.

The Variable Interest Model has special provisions to determine whether a reporting entity with a variable interest in specified assets of an entity has a variable interest in the entity as a whole. A variable interest in specified assets of an entity is a variable interest in the entity as a whole only if (1) the fair value of the specified assets is more than half of the fair value of the entity’s total assets, or (2) the variable interest holder has another variable interest in the entity as a whole (except interests that are insignificant or have little or no variability).

Illustration 5-20: Interests in specified assets

Assume a VIE has total assets with a fair value of $1 million of which $300,000 is a machine that is financed with debt. To protect itself against a decline in the value of the equipment, the entity obtains a residual value guarantee on the machine from Company ABC, which guarantees that the machine will be worth at least $200,000 when the debt is due.

Analysis
In this case, Company ABC has a variable interest in a specified asset of the entity, but not in the entity as a whole. The machine’s fair value of $300,000 is less than half of the fair value of the VIE’s total assets of $1 million. With no variable interest in the VIE as a whole, Company ABC cannot be required to consolidate it.

When determining whether an asset in which a reporting entity has a specified interest is worth more or less than half of the fair value of the entity’s total assets, we believe the entire fair value of the asset should be used (rather than the amount of the specific exposure) in performing this calculation. Using the example above, when determining whether the machine in which Company ABC has a specified interest is worth more or less than half of the assets in the entity, the entire fair value of the machine ($300,000) should be used rather than the amount of the specific exposure ($200,000).

In addition, we believe that it is appropriate for reporting entities holding variable interests in an entity’s assets to determine whether the variable interests represent a variable interest in the entity as a whole or only in the specified assets based on the aggregate value of the assets in which it holds a variable interest. For example, if a VIE holds four assets that are valued at a total of approximately $20 million and one reporting entity has
three separate interests in three of the four assets, the reporting entity should aggregate those three assets to determine whether they comprise greater than half of the fair value of the entity's total assets. If the aggregate fair value of the three assets is less than $10 million, the reporting entity would not have a variable interest in the entity. However, if the aggregate fair value of the three assets exceeds $10 million, the reporting entity would be deemed to have a variable interest in the entity as a whole.

Determining whether a reporting entity has a variable interest in the specified assets of an entity also could affect the evaluation of whether an entity is a VIE. One characteristic of a VIE is that it does not have sufficient equity at risk to absorb its expected losses such that it requires additional subordinated financial support. (See Section 7.2 for further guidance).

Excerpt from Accounting Standards Codification

Consolidation – Overall
Recognition – Variable Interest Entities
810-10-25-56
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.

If a reporting entity has only a variable interest in the specified assets of an entity and not the entity as a whole, the expected losses absorbed by the variable interests in those specified assets are excluded when determining whether the entity has sufficient equity at risk. In other words, in determining whether an entity has sufficient equity to finance its activities, the equity holders do not have to support the expected losses that are absorbed by variable interest holders that hold interests only in specified assets of the entity (and therefore do not have a variable interest in the VIE).

Illustration 5-21: Interests in specified assets

Assume that an entity with a $50 equity investment at risk acquires two assets, Asset A and Asset B, for use in its operations. The fair value of Asset A is $100. The fair value of Asset B is $300. The fair value of all of the entity's assets is $500. The entity finances the costs of Asset A and Asset B in their entirety with debt from Lender A and Lender B, respectively. The lenders have recourse only to the cash flows generated by Asset A and Asset B, respectively, for payment of the loans and do not have access to the general credit of the entity (i.e., the borrowings are nonrecourse).

The expected losses of the entity are $100. The expected losses associated with Asset A are $60. The expected losses associated with Asset B are $30. All expected losses associated with Asset A and Asset B will be absorbed by the lenders.

Analysis
In this example, Lender A does not have a variable interest in the entity, because the fair value of the asset in which it has a variable interest (Asset A) is less than half of the fair value of the total assets of the entity ($100/$500 = 20%).

However, Lender B does have a variable interest in the entity because the fair value of the asset in which it has a variable interest (Asset B) is more than half of the fair value of the total assets of the entity ($300/$500 = 60%).

The expected losses of the entity when evaluating the sufficiency of the entity's equity investment at risk are $40 ($100 expected losses of the entity as a whole, less expected losses of $60 relating to Asset A, which will be absorbed by Lender A). Accordingly, this entity would have sufficient equity because its $50 equity investment at risk exceeds its expected losses of $40.
ASC 810-10-15-14(a) refers to expected losses of an entity when determining the sufficiency of the equity investment at risk for the entire entity. The provisions of ASC 810-10-25-55 and 25-56 determine whether expected losses that will be absorbed by guarantees or other variable interests in specified assets of the entity are expected losses of the entity when determining whether an entity has sufficient equity investment at risk. The guidance in ASC 810-10-25-55 and 25-56, therefore, always should be applied before determining whether an entity has a sufficient at-risk equity investment.

The following example illustrates how an interest in specified assets of an entity affects the calculation of an entity’s expected losses:

<table>
<thead>
<tr>
<th>Illustration 5-22: Interest in specified assets and effect on calculation of entity’s expected losses</th>
</tr>
</thead>
</table>
| Company A guarantees the collection of $750 of a $1,000 receivable held by an entity. The entity's total assets are $2,200. Company A has a variable interest in only a specified asset of the entity (i.e., the receivable) because that asset is less than half of the total fair value of the entity’s assets, and Company A has no other interests in the entity as a whole. Therefore, the expected losses related to the guarantee are not considered part of the expected losses of the entity when determining the sufficiency of the equity at risk in the entity. The expected losses and expected residual returns on that $1,000 receivable are as follows (assume all amounts are at present value):

<table>
<thead>
<tr>
<th>Possible outcome</th>
<th>Estimated cash flows</th>
<th>Probability</th>
<th>Expected cash flows</th>
<th>Expected losses</th>
<th>Expected residual returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000</td>
<td>50%</td>
<td>$500</td>
<td>$80</td>
<td>$80</td>
</tr>
<tr>
<td>2</td>
<td>800</td>
<td>35%</td>
<td>280</td>
<td>14</td>
<td>-</td>
</tr>
<tr>
<td>3</td>
<td>400</td>
<td>15%</td>
<td>60</td>
<td>66</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>$840</td>
<td></td>
<td></td>
<td>$80</td>
<td>$80</td>
</tr>
</tbody>
</table>

As shown above, the expected losses on the receivable are $80. The expected losses on the other assets in the entity are $250. Therefore, the total expected losses of the entity are $330.

The guarantee would absorb a portion of the expected losses when the estimated cash flows are less than $750, which in this example is possible outcome #3. The expected losses in possible outcome #3 are $66, and the portion of the expected losses that the guarantee absorbs is $45.

Analysis

Because the guarantee represents a variable interest in a specified asset, the expected losses related to the guarantee are not considered part of the expected losses of the entity when determining whether the entity’s equity at risk is sufficient.

Total entity expected losses $330
Less: Expected losses absorbed by a variable interests in specified assets 45
Entity’s expected losses $285

If the equity investment at risk exceeds $285, the equity investment would be deemed sufficient, and the entity would not be a VIE (this assumes the other criteria are not met). Conversely, if the equity investment at risk is less than $285, the entity would be a VIE.

The risk that the guarantor does not perform when called upon should be included in the calculation of the entity’s expected losses. For example, if, based on the guarantor’s credit risk, it was determined that the guarantor could absorb only $43 of expected losses instead of $45, only $43 would be excluded from the calculation of the entity’s expected losses.

It’s important to note that a reporting entity with a variable interest in specified assets of a VIE should carefully consider whether those specified assets represent a distinct VIE (known as a silo) that is separate from the larger host VIE (see Chapter 6).
6

Silos

6.1 Introduction

Excerpt from Accounting Standards Codification

Consolidation – Overall

Recognition – Variable Interest Entities

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.

810-10-25-58

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.

Portions of entities, such as divisions, departments and branches, generally are not considered separate entities when applying the provisions of the Variable Interest Model (see Chapter 4). However, a reporting entity with a variable interest in specified assets of a VIE should carefully consider whether those specified assets, and related liabilities, represent a VIE known as a silo, which is separate from the larger host VIE. A silo can be thought of as a VIE within a VIE.

A silo exists if “essentially all” of the assets, liabilities and equity of the deemed entity (i.e., the silo) are separate from the larger host entity and specifically identifiable. In other words, a silo exists when essentially none of the returns of the assets of the silo inure to holders of variable interests in the host entity, and essentially none of the liabilities of the silo are payable from the remaining assets attributable to variable interests in the host entity. Both of these conditions must be present for a silo to exist.

While the FASB did not define the term “essentially all,” we understand from discussions with the FASB staff that the Board members were concerned about the complexities arising from accounting allocations when liabilities or other interests were not entirely specified to an asset. As a result, the FASB included the “essentially all” language in the Variable Interest Model. We generally have interpreted “essentially all” to mean that 95% or more of the assets, liabilities and equity of the potential silo are specifically identifiable and economically separate from the host entity’s remaining assets, liabilities and equity. Because “essentially all” is a high threshold to overcome, we believe the existence of silos will be limited in practice.
Assume an asset is financed with nonrecourse debt representing 95% or more of the asset’s fair value, and the asset is leased to a lessee under a lease containing a fixed-price purchase option (such that the lessee receives essentially all returns associated with increases in the value of the leased asset). In this example, we believe the asset would represent a silo. However, consider the same example (including the fixed-price purchase option), except the asset is financed with nonrecourse debt representing 94% of its fair value. In that circumstance, we do not believe that essentially all of the leased asset and related obligations would be economically separate from the host entity. Therefore, no silo exists.

### Illustration 6-1: Silo identification

#### Example 1

Company A, Company B and Company C each lease one of three buildings owned by an entity. Each lessee provides a first dollar risk of loss residual value guarantee on the building it leases, and the entity has debt that is cross-collateralized by the three buildings (i.e., all three of the buildings support repayment of the debt).

**Analysis**

In this example, no silos exist. Each asset is not essentially the only source of payment for the entity’s debt (the debt is cross-collateralized by all three buildings). Also, the other variable interest holders of the entity (outside of Company A, Company B and Company C) will receive returns associated with increases in the value of the buildings.

#### Example 2

Assume a lessor entity’s balance sheet is as follows (on a fair value basis):

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 20</td>
</tr>
<tr>
<td>Building A (leased to Company A)</td>
<td>120</td>
</tr>
<tr>
<td>Building B (leased to Company B)</td>
<td>100</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 240</td>
</tr>
<tr>
<td>Debt (recourse only to Building A)</td>
<td>$ 120</td>
</tr>
<tr>
<td>Debt (recourse only to Building B)</td>
<td>50</td>
</tr>
<tr>
<td>Equity</td>
<td>70</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$ 240</td>
</tr>
</tbody>
</table>

Additionally, Company A has a fixed-price purchase option that allows it to purchase Building A for $120. No such option exists for Building B.

**Analysis**

In this example, a silo exists for Building A. The building has been wholly financed with nonrecourse debt such that all losses associated with decreases in the value of the building are attributable to the lender (i.e., none of the liabilities of the silo are payable from the assets of the remaining entity). In addition, all returns created by an increase in the value of the building will inure to Company A through the exercise of the fixed-price purchase option (i.e., if the building appreciates in value, Company A, and not the lessor entity’s variable interest holders, will receive this benefit).

No silo exists for Building B because, the recourse debt tied to that building constitutes only 50% of the building’s fair value (not 95%), and the remaining fair value is supported by equity that also supports the host entity’s other assets. In addition, the equity holders receive any returns resulting from an increase in the value of Building B.
Example 3

Assume a lessor entity owns three buildings. Each building is separately leased to an unrelated third party (Company A, Company B and Company C, respectively). Each lease contains a $100 fixed-price purchase option and provides a first dollar risk of loss residual value guarantee of $85 to the lessor. The lessor’s balance sheet looks as follows at the inception of the leasing arrangements (on a fair value basis):

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building A (leased to Company A)</td>
<td>$100</td>
</tr>
<tr>
<td>Building B (leased to Company B)</td>
<td>100</td>
</tr>
<tr>
<td>Building C (leased to Company C)</td>
<td>100</td>
</tr>
<tr>
<td>Total assets</td>
<td>$300</td>
</tr>
</tbody>
</table>

Analysis

In this example, no silos exist. Although the lease agreements of Company A, Company B and Company C each contain a residual value guarantee and a fixed-price purchase option that result in losses being absorbed by, and returns received by, each lessee, each asset is not essentially the only source of payment for the VIE’s debt. The debt is cross-collateralized by all three buildings. Accordingly, essentially all of the assets and liabilities of any potential silo are not economically separate from the host entity.

Example 4

Assume a lessor entity owns three buildings. Each building is separately leased to an unrelated third party (Company A, Company B and Company C, respectively). Each lease contains a $100 fixed-price purchase option and provides a first dollar risk of loss residual value guarantee of $85 to the lessor. The lessor’s balance sheet is as follows at the inception of the leasing arrangements (on a fair value basis):

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building A (leased to Company A)</td>
<td>$100</td>
</tr>
<tr>
<td>Building B (leased to Company B)</td>
<td>100</td>
</tr>
<tr>
<td>Building C (leased to Company C)</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>$300</td>
</tr>
</tbody>
</table>

Analysis

In this example, three separate silos exist. Each silo consists of a building, its related nonrecourse debt and a pro rata allocation of the lessor’s equity because essentially all of each specified asset (the building) and its specified liability (the nonrecourse debt) or other variable interests (the lessee’s residual value guarantees and fixed-price purchase options) are economically separate from the remaining entity. Additionally, essentially none of the returns of each building can be used by the remaining entity and essentially none of each debt interest is payable from the assets of the remaining entity. Although the total equity has losses and returns from all three buildings and looks to all three assets for its return, the amount of the interest is not deemed significant enough to prevent the entity from being carved up into three separate silos. The same conclusion would be reached even if no equity existed and instead the $12 was financed with recourse debt.
Example 5

Assume a lessor entity owns three buildings. Each building is separately leased to an unrelated third party (Company A, Company B and Company C, respectively). Each lease contains a $100 fixed-price purchase option and provides a first dollar risk of loss residual value guarantee of $85 to the lessor. Additionally, the lessee of Building A made a $6 prepayment of rent at inception of the leasing arrangement. The lessor’s balance sheet looks as follows at the inception of the leasing arrangements (on a fair value basis):

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 6</td>
</tr>
<tr>
<td>Building A (leased to Company A)</td>
<td>100</td>
</tr>
<tr>
<td>Building B (leased to Company B)</td>
<td>100</td>
</tr>
<tr>
<td>Building C (leased to Company C)</td>
<td>100</td>
</tr>
<tr>
<td>Nonrecourse Debt – Building A</td>
<td>$ 94</td>
</tr>
<tr>
<td>Nonrecourse Debt – Building B</td>
<td>94</td>
</tr>
<tr>
<td>Nonrecourse Debt – Building C</td>
<td>94</td>
</tr>
<tr>
<td>Deferred Revenue – Building A</td>
<td>6</td>
</tr>
<tr>
<td>Equity</td>
<td>18</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 306</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$ 306</td>
</tr>
</tbody>
</table>

Analysis

In this example, no silo exists for Building B or Building C because less than essentially all of the fair value of the specified assets (the buildings) is economically separate from the remaining entity. Each building has been financed partially on a nonrecourse basis, and a sufficient amount of losses inure to the entity's equity interest holder, whose interest is not targeted to specific assets of the entity (i.e., the specified liabilities for Building B and Building C are less than 95%). However, Company A would evaluate Building A as a separate silo. The $6 rent prepayment made by Company A represents a liability of the lessor entity that can be recovered by Company A only through the use of the leased asset. Accordingly, essentially all of the losses and returns of Building A relate to or inure to a specified liability or other variable interest of the lessor entity. In other words, none of the returns of Building A can be used by the remaining entity and essentially none of the nonrecourse debt and deferred revenue for Building A is payable from the assets of the remaining host entity.

We believe structuring fees paid to the lessor entity or directly to the lessor entity’s equity holder should be evaluated similarly to prepaid rent.

6.2 Determining whether the host entity is a VIE when silos exist
(Updated February 2016)

A silo can be consolidated separately from the host entity only when the host entity is a VIE.

When a silo exists, all of the expected losses and expected residual returns attributable to variable interest holders in the silo should be excluded when determining whether the host entity has sufficient equity to finance its activities without additional subordinated financial support, even if that silo has no primary beneficiary.

If after excluding expected losses absorbed by variable interests in one or more silos (and specified assets, if applicable), the host entity’s equity investment at risk is sufficient to absorb the remaining expected losses, the entity is not a VIE. That is, assuming no other VIE criteria are met, the entity as a whole would be considered a voting interest entity.

The concept of silos does not exist in the Voting Model. Therefore, if the host entity is a voting interest entity, the reporting entity with a controlling financial interest in the entity consolidates all of the assets, liabilities and equity of the entity. Conversely, if it is determined that the host entity is a VIE, the host...
entity and the silo should be evaluated separately for consolidation. Without requiring a silo to be separated from the VIE host entity, the same assets and liabilities would be consolidated by two parties, which the FASB believes is an undesirable outcome.

If only a “shell” entity remains after all silos are removed, careful consideration of the criteria for determining whether an entity is a VIE is required to determine whether the “shell” entity, exclusive of the activity in the silos, is a VIE.

Illustration 6-2: Effect of silos on the host entity’s expected losses and expected residual returns

Lease Co.’s balance sheet is as follows (on a fair value basis):

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 5</td>
</tr>
<tr>
<td>Building A (leased to Company A)</td>
<td>120</td>
</tr>
<tr>
<td>Building B (leased to Company B)</td>
<td>100</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 225</td>
</tr>
<tr>
<td>Debt (recourse only to Building A)</td>
<td>$ 100</td>
</tr>
<tr>
<td>Debt (recourse only to Building B)</td>
<td>97</td>
</tr>
<tr>
<td>Equity</td>
<td>28</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$ 225</td>
</tr>
</tbody>
</table>

Building A is leased under an operating lease that does not include a residual value guarantee, fixed-price purchase option or other features. Building B’s lease terms include a fixed-price purchase option giving Company B the right to acquire the building from Lease Co. for $100.

Assume expected losses of the entity are $65. Also, assume that expected losses relating to Building A are $20, of which $4 are absorbed by the lender and $16 by Lease Co.’s equity holder. Expected losses relating to Building B are $45, of which $43 are absorbed by the lender and $2 by Lease Co.’s equity holder. (Appendix A describes the calculation of expected losses and expected residual returns.)

Analysis

Building A is not a silo because nonrecourse debt represents less than essentially all of Building A’s financing ($100 debt/$120 asset value = 83%, which is less than 95%), and its returns inure to Lease Co.’s equity holder. Building B is a silo because nonrecourse debt represents essentially all of Building B’s financing ($97 debt/$100 asset value = 97%, which is more than 95%), and all of the returns associated with the building inure to the lessee, Company B, due to the fixed-price purchase option in the lease. In other words, none of the returns of Building B can be used by the remaining entity and essentially none of the nonrecourse debt for Building B is payable from the assets of the remaining entity.

The amount of Lease Co.’s equity investment at risk when determining whether the entity is a VIE is $25. The amount of equity at risk ($28) excludes equity amounts relating to the Building B silo of $3. This amount is subtracted from the equity of the host entity to arrive at the amount of equity investment at risk.

Expected losses of the entity when determining the sufficiency of Lease Co.’s equity investment at risk are $20. This amount is derived from the total expected losses of the entity of $65. All expected losses relating to the Building B silo ($45) are subtracted from this amount. Accordingly, Lease Co.’s equity investment at risk of $25 is sufficient.

Question 6.1 If the host entity doesn’t hold any assets, liabilities or equity other than those attributed to the silo(s), would it be a VIE?

Yes. We believe that the host entity would be a VIE if it doesn’t hold any assets, liabilities or equity other than those attributed to the silo. We understand that the SEC staff shares this view.
**Question 6.2**

Is a silo required to have a primary beneficiary in order to be excluded from the VIE host entity?

No. As illustrated below, a silo is not required to have a primary beneficiary in order to be excluded from the VIE host entity.

In considering whether a reporting entity should consolidate a silo, the variable interest holder should determine whether it has (1) the power to direct activities of a silo that most significantly impact the economic performance of the silo and (2) the obligation to absorb losses of the silo that could potentially be significant to the silo or the right to receive benefits from the silo that could potentially be significant to the silo. A party (if any) that meets those conditions is the primary beneficiary and should consolidate the silo. See Chapter 8 for further guidance on identifying the primary beneficiary.

**Illustration 6-3: Excluding a silo’s assets, liabilities and equity from the host entity**

Assume that in addition to other assets it holds, an entity owns a building and leases it to Company A. Company A’s lease contains a $100 fixed-price purchase option. The building leased to Company A was financed entirely through nonrecourse debt funded equally by Lender A and Lender B. Assume the entity’s balance sheet at the inception of the leasing arrangement is as follows (on a fair value basis):

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building (leased to Company A)</td>
<td>Nonrecourse Debt – Lender A</td>
</tr>
<tr>
<td></td>
<td>100</td>
</tr>
<tr>
<td>Other assets</td>
<td>Nonrecourse Debt – Lender B</td>
</tr>
<tr>
<td></td>
<td>300</td>
</tr>
<tr>
<td></td>
<td>Other liabilities</td>
</tr>
<tr>
<td></td>
<td>280</td>
</tr>
<tr>
<td></td>
<td>Equity</td>
</tr>
<tr>
<td></td>
<td>20</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>Total liabilities and equity</strong></td>
</tr>
<tr>
<td></td>
<td><strong>400</strong></td>
</tr>
</tbody>
</table>

**Analysis**

A silo exists because the losses and returns of the building leased to Company A inure to specified liabilities (the nonrecourse debt) or other variable interests (the lessee’s fixed-price purchase option). In other words, the specified assets and liabilities are economically separate as none of the returns of the building can be used by the remaining entity and none of the nonrecourse debt for the building is payable from the assets of the remaining entity. Regardless of whether the silo has a primary beneficiary, the expected losses and expected residual returns related to the silo should be excluded from the larger entity in determining whether the entity is a VIE.

If the entity is determined to be a VIE and that entity has a primary beneficiary, we do not believe that primary beneficiary is required to consolidate any silos in the entity (even if those silos do not have a primary beneficiary). Otherwise, the primary beneficiary of the entity would be required to consolidate assets and liabilities in which it may have no economic interest.

**Question 6.3**

A VIE is determined to have one or more silos that are each consolidated by their respective primary beneficiaries. The reporting entity that established the VIE is determined to be the primary beneficiary of the larger VIE and consolidates that VIE’s assets, liabilities and noncontrolling interests, excluding the silos. The reporting entity is required by a lender to issue GAAP financial statements of the VIE. Should the silos be included in the VIE’s separate standalone financial statements?

Yes. The silos should not be removed from the balance sheet of the VIE’s standalone GAAP financial statements. ASC 810-10’s Variable Interest Model provides consolidation guidance and does not affect the standalone financial statements of the VIE.
6.3 Effect of silos on determining variable interests in specified assets

If a silo exists in a larger host entity, we believe the fair value of the silo’s assets should be deducted from the fair value of the host entity’s total assets before determining whether a reporting entity with a variable interest in specified assets of the entity has a variable interest in the host entity as a whole. See Section 5.5 for further guidance on specified assets.

Illustration 6-4: Effect of silos on determining variable interests in specified assets

Lease Co.’s balance sheet is as follows (on a fair value basis):

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 5</td>
</tr>
<tr>
<td>Building A (leased to Company A)</td>
<td>120</td>
</tr>
<tr>
<td>Building B (leased to Company B)</td>
<td>100</td>
</tr>
<tr>
<td>Building C (leased to Company C)</td>
<td>100</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 325</td>
</tr>
</tbody>
</table>

Company A has a fixed-price purchase option to acquire Building A from Lease Co. for $120. Building B’s lease terms do not include a residual value guarantee, fixed-price purchase option or other features. Building C’s lease terms include a fixed-price purchase option giving Company C the right to acquire the building from Lease Co. for $100.

Analysis

Building A is not a silo. Even though all returns inure to Company A due to the fixed-price purchase option in the lease, the building has been financed with less than 95% nonrecourse debt ($100 debt/$120 asset value = 83%). Building B is not a silo even though it has been financed in its entirety with nonrecourse financing, because its returns inure to Lease Co.’s equity holder.

However, Building C is a silo. Building C has been financed with 97% nonrecourse financing ($97 debt divided by $100 asset value = 97%), and all of the returns associated with the building inure to the lessee, Company C, because of the fixed-price purchase option in the lease. In other words, none of the returns of Building C can be used by the remaining entity and essentially none of the nonrecourse debt for Building C is payable from the assets of the remaining entity.

Total assets of the entity, less the fair value of Building C (the silo asset), are $225 ($325 less the $100 fair value of Building C). Because Building B represents less than half of these assets ($100 of $225), the Building B lender has a variable interest in Building B, only, and not a variable interest in the Lease Co. host entity as a whole. However, since Building A represents more than half of the fair value of the assets of the entity (excluding Building C), Company A’s and the lender’s variable interests in Building A (based on the fixed-price purchase option and the nonrecourse loan, respectively) are variable interests in the Lease Co. entity as a whole (see Section 5.5). If Lease Co. is a VIE, Company A, the lender with recourse only to Building A, and the equity holder, each should consider whether it should consolidate the entity (excluding Building C, the related $97 nonrecourse debt and $3 of equity that comprise the silo) as the primary beneficiary. Additionally, if Lease Co. is a VIE, the Building C silo should be evaluated separately for consolidation by those parties holding variable interests in the silo (Company C, the related lender and the equity holder of Lease Co.).
Question 6.4 Assume a variable interest in specified assets is a variable interest in the entity as a whole (because the fair value of the specified assets of a VIE are greater than 50% of the fair value of the entity’s total assets). Can such assets also represent a silo?

Yes. The Variable Interest Model treats silos as distinct VIEs whose assets, liabilities and equity are separate from the large host VIE. Therefore, silos should be evaluated for consolidation regardless of their size, if the host entity is a VIE.

Illustration 6-5: Silo assets greater than 50% of the fair value of the VIE’s total assets

Lease Co.’s balance sheet is as follows (on a fair value basis):

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 5</td>
</tr>
<tr>
<td>Building A (leased to Company A)</td>
<td>Debt (recourse only to Building A) $ 100</td>
</tr>
<tr>
<td>Building B (leased to Company B)</td>
<td>Debt (recourse only to Building B) $ 100</td>
</tr>
<tr>
<td>Building C (leased to Company C)</td>
<td>Debt (recourse only to Building C) $ 388</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 625</td>
</tr>
<tr>
<td></td>
<td>Total liabilities and equity $ 625</td>
</tr>
</tbody>
</table>

Company A has a fixed-price purchase option to acquire Building A from Lease Co. for $120. Building B’s lease terms do not include a residual value guarantee, fixed-price purchase option or other features. Building C’s lease terms include a fixed-price purchase option that gives Company C the right to acquire the building from Lease Co. for $400.

Analysis

The first determination is whether any silos exist in Lease Co. In this example, Building A is not a silo, because the building has been financed with less than 95% nonrecourse debt ($100 debt/$120 asset value = 83%). Building B is not a silo, even though it has been financed in its entirety with nonrecourse financing, because its returns inure to Lease Co.’s equity holder.

While Company C has a variable interest in specified assets that qualifies as a variable interest in Lease Co. (Building C represents approximately two-thirds of Lease Co.’s assets), it is a silo because it has been financed with 97% nonrecourse financing ($388 debt divided by $400 asset value = 97%), and all of the returns associated with the building inure to the lessee, Company C, because of the fixed-price purchase option in the lease.

The next determination is whether any variable interest holders with interests in specified assets have variable interests in the entity as a whole. The entity’s total assets, less the fair value of Building C (because silos are excluded), are $225 ($625 less the $400 fair value of Building C). Because Building B represents less than half of these assets ($100 of $225), the Building B lender has a variable interest in Building B only, and not a variable interest in the Lease Co. host entity as a whole. However, because Building A represents more than half of the fair value of the assets of the entity (excluding Building C), Company A’s and the lender’s variable interests in Building A (based on the fixed-price purchase option and the nonrecourse loan, respectively) are variable interests in the Lease Co. host entity as a whole.

If Lease Co. is a VIE, Company A, the lender with recourse only to Building A, and the equity holder each should consider whether it should consolidate the entity (excluding Building C, the related $388 nonrecourse debt and $12 of equity that comprise the silo) as the primary beneficiary. Additionally, if Lease Co. is a VIE, the Building C silo should be evaluated separately for consolidation by those parties holding variable interests in the silo (Company C, the related lender and the equity holder of Lease Co.).
6.3.1 Relationship between specified assets and silos

A reporting entity with a variable interest in specified assets of a VIE should carefully consider whether those specified assets represent a distinct VIE known as a silo, which is separate from the larger host VIE. However, as described in Question 6.4, silos also can exist when the fair value of the specified assets is more than half of the fair value of the entity's total assets.

If a silo exists in a larger host entity, we believe the fair value of the silo’s assets should first be deducted from the fair value of the host entity's total assets before determining whether a reporting entity with a variable interest in specified assets of the entity has a variable interest in the host entity as a whole. See Illustration 6-4.

Variable interests in specified assets (and not the entity as a whole) and silos both affect the VIE analysis. When determining whether an entity is a VIE, all of the expected losses absorbed by variable interests in silos and specified assets are excluded when determining whether the entity has sufficient equity at risk to absorb its expected losses. (See Chapter 7 for further guidance on the characteristics of a VIE and determining whether an entity has sufficient equity at risk).

However, a key distinction is that a silo can be consolidated separately from the host entity when the host entity is a VIE. That is, a reporting entity with a variable interest in a silo is subject to consolidating the assets, liabilities and equity of that silo separately from the host VIE. A reporting entity with a variable interest in the specified assets of a VIE and not the VIE as a whole is not subject to consolidating the VIE (or the specified assets). Rather, a reporting entity with a variable interest in the specified assets of a VIE would account for its interest in those assets in accordance with other applicable GAAP.
7 Determining whether an entity is a VIE

7.1 Introduction
A reporting entity that concludes that it holds a variable interest or interests in an entity must evaluate whether the entity is a VIE. The initial determination is made on the date on which the reporting entity becomes involved with the entity, which generally is when it obtains a variable interest (e.g., an investment, a loan, a lease) in the entity (see Section 7.5). If an entity is not a VIE, the reporting entity will evaluate the entity for consolidation using the provisions of the Voting Model (see Appendix C for guidance on the Voting Model). If a reporting entity does not have a variable interest in an entity, the entity is not subject to consolidation under ASC 810. The reporting entity should account for its interest in accordance with other GAAP.

The distinction between a VIE and other entities is based on the nature and amount of the equity investment and the rights and obligations of the equity investors. When an entity has sufficient equity to finance its operations and the equity investor or investors make the decisions to direct the significant activities of the subsidiary through their equity interests, consolidation based on majority voting interest is generally appropriate. Entities that fall under the traditional Voting Model have equity investors that expose themselves to variability (i.e., expected returns and expected losses) in exchange for control through voting rights.

The Voting Model is not appropriate when an entity does not have sufficient equity to finance its operations without additional subordinated financial support or when decisions to direct significant activities of the entity involve an interest other than the equity interests.

An entity is a VIE if it has any of the following characteristics:

- The entity does not have enough equity to finance its activities without additional subordinated financial support. (See Section 7.2.)
- The equity holders, as a group, lack the characteristics of a controlling financial interest. (See Section 7.3.)
- The entity is established with non-substantive voting rights (i.e., an anti-abuse clause). (See Section 7.4.)

7.2 The entity does not have enough equity to finance its activities without additional subordinated financial support

The Codification excerpt below describes the first characteristic of a VIE. See Sections 7.3 and 7.4 for excerpts related to the two other characteristics.
Excerpt from Accounting Standards Codification

Consolidation – Overall

Scope and Scope Exceptions – Variable Interest Entities

810-10-15-14

A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.):

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.

To be considered a voting interest entity, the entity must have equity investments at risk that are sufficient to permit it to carry on its activities without additional subordinated financial support (even if that support has been provided by one or more holders of an at-risk equity investment). That is, the entity must have enough equity to induce lenders or other investors to provide the funds necessary at market terms for the entity to conduct its activities. As an extreme example, an entity that is financed with no equity is a VIE. An entity financed with some amount of equity also may be a VIE pending further evaluation.

When measuring whether equity is sufficient for an entity to finance its operations, only equity investments at risk should be considered. “Equity” means an interest that is required to be reported as equity in that entity’s US GAAP financial statements (see Section 7.2.1). That is, equity instruments classified as liabilities under US GAAP are not considered equity in the Variable Interest Model. Determining whether an equity investment is at risk is described in Section 7.2.2.
Once a reporting entity determines the amount of GAAP equity that is at economic risk, the reporting entity must determine whether that amount is sufficient for the entity to finance its activities without additional subordinated financial support. This can be demonstrated in one of three ways: (1) by demonstrating that the entity has the ability to finance its activities without additional subordinated financial support; (2) by having at least as much equity as a similar entity that finances its operations with no additional subordinated financial support or (3) by comparing the entity’s at-risk equity investment with its calculated expected losses. These methods of demonstrating the sufficiency of an entity’s at-risk equity are discussed in more detail in Section 7.2.3.

### 7.2.1 Forms of investments that qualify as equity investments

- **The entity does not have enough equity to finance its activities without additional subordinated financial support.**

- **The equity holders, as a group, lack the characteristics of a controlling financial interest.**

- **The legal entity is structured with non-substantive voting rights (i.e., anti-abuse clause).**

#### When determining whether an entity has sufficient equity, only GAAP equity that is at risk should be considered.

- **Equity “at risk”:**
  - Includes only equity investments in the entity that participate significantly in both profits and losses. If an equity interest participates significantly in only profits or only losses, the equity is not at risk.
  - Excludes equity interests that were issued by the entity in exchange for subordinated interests in other VIEs.
  - Excludes amounts (e.g., fees, charitable contributions) provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity.
  - Excludes amounts financed for the equity holder (e.g., by loans or guarantees of loans) directly by the entity or by other parties involved with the entity.

For the sufficiency of equity test, an equity investment is an interest that is required to be reported as equity in the entity’s US GAAP financial statements. Common stock is an example. Certain forms of preferred stock – such as perpetual preferred stock – also are considered equity investments. However, ASC 480 requires mandatorily redeemable preferred stock to be classified as a liability, which means it is not an equity investment for the sufficiency of equity test.

The following are common forms of investments that may be considered an equity investment:

- **Common stock**
  - Voting and nonvoting

- **Certain forms of perpetual preferred stock, if the stock significantly participates in the profits and losses of the entity (see Question 7.4)**
  - Voting and nonvoting
  - Participating and nonparticipating
  - Convertible and nonconvertible

- **Preferred stock classified in temporary equity (e.g., because it is redeemable upon the occurrence of an event that is not solely under the entity’s control, such as a change in control provision) pursuant to ASR 268**

- **Warrants to purchase equity interests**
LLC member interests
• General partnership interests
• Limited partnership interests
• Certain trust beneficial interests

While there may not be substantive economic differences between an entity that is capitalized with equity and an entity that is capitalized solely with subordinated debt (i.e., in both cases, the residual holder absorbs the first dollar risk of loss), the Variable Interest Model indicates that the form of the instrument is determinative.

Question 7.1 Are commitments to fund losses or contribute equity considered equity investments?

Commitments to fund losses or contribute equity are not reported as equity in the GAAP balance sheet of the entity under evaluation. As a result, neither can be considered an equity investment when determining whether the entity has sufficient equity. However, such commitments generally would be variable interests in the entity (see Chapter 5).

Question 7.2 Are amounts reported in other comprehensive income (e.g., amounts arising from hedge accounting pursuant to ASC 815 or relating to available-for-sale securities accounted for under ASC 320) considered in determining the amount of the equity investment at risk?

In determining whether an entity is a VIE, the fair value of the equity investment at risk at the date of assessment should be used to assess whether the equity investment at risk is sufficient to absorb the entity’s expected losses. Presumably, the fair value of the equity interests already would include the effects of items reported as components of other comprehensive income or loss. Accordingly, these items, favorable or unfavorable, should be considered in determining the fair value of the equity investment at risk but should not be double-counted.

Question 7.3 How should the sufficiency of the equity investment at risk of an entity that produces refined coal be evaluated?

Internal Revenue Code Section 45(c) (7) provides for refined coal tax credits. These tax credits are intended to incentivize the reduction of emissions generated when coal is burned to produce steam.

Generally, tax credits are available provided the facility qualifies under the relevant tax code and demonstrates that the production process results in emission reductions. The amount of the credit earned by the taxpayer is dependent on the tons of coal processed and sold for the production of steam by third party purchasers. The taxpayer also must demonstrate that it bears the risks associated with ownership of the feedstock coal that produces the refined coal.

Investors in refined coal producing facilities generally receive their returns from a combination of (1) realization of tax credits, (2) deductions for operating losses and (3) depreciation of the refined coal production equipment.

17 Generally, this is demonstrated through testing performed by independent laboratories and chemists.
Structures used to facilitate investments in refined coal tax credit facilities are usually established as limited partnerships or limited liability companies that pass the tax benefits associated with the entity’s production of refined coal directly to the investors. This structure enables a taxpayer to receive credits in proportion to its ownership in the facility while providing some limitation on liability, particularly if the taxpayer is a limited partner or a non-managing member of an LLC.

Investors in a refined coal facility may purchase an interest in the entity from a co-investor for a relatively small initial cash payment and contingent consideration based on the amount of tax credits generated by the facility (an “earn-out”). Operations of refined coal production facilities usually result in operating losses that the investors must fund through ongoing capital contributions, regardless of their ability to utilize the tax credits.

We believe that, qualitatively, a typical refined coal structure will be a VIE because the investors generally fund operating losses through ongoing capital contributions. As discussed in the response to Question 7.1, a commitment to fund losses is not reported as equity in the GAAP balance sheet of the entity under evaluation. Consequently, the commitment to fund losses cannot be considered an equity investment at risk when determining whether the entity has sufficient equity. We believe that a refined coal structure that has an insufficient amount of equity at the evaluation date to fund its future operating losses will be a VIE even if, quantitatively, the fair value of the entity’s equity investment at risk exceeds the entity’s expected losses (see Question A.5 for our views on including the investors’ tax benefits in the calculation of expected losses). We understand the SEC staff shares this view.

7.2.2 Determining whether an equity investment is at risk

Although all of the interests listed in Section 7.2.1 may be reported as equity in an entity’s US GAAP balance sheet, the features and source of each equity interest must be carefully evaluated to ensure that the equity interest is at risk. For equity to be at risk, it must have all of the characteristics described in ASC 810-10-15-14(a). Each of these characteristics is described below.

7.2.2.1 Equity investment participates significantly in both profits and losses

- The entity does not have enough equity to finance its activities without additional subordinated financial support.
- The equity holders, as a group, lack the characteristics of a controlling financial interest.
- The entity is structured with non-substantive voting rights (i.e., anti-abuse clause).

When determining whether an entity has sufficient equity, only GAAP equity that is at risk should be considered.

- Equity “at risk”:
  - Includes only equity investments in the entity that participate significantly in both profits and losses. If an equity interest participates significantly in only profits or only losses, the equity is not at risk.
  - Excludes equity interests that were issued by the entity in exchange for subordinated interests in other VIEs.
  - Excludes amounts (e.g., fees, charitable contributions) provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity.
  - Excludes amounts financed for the equity holder (e.g., by loans or guarantees of loans) directly by the entity or by other parties involved with the entity.

An equity investment must participate significantly in profits and losses to be at risk. ASC 810 does not provide implementation guidance on how to make this determination, but we believe that this provision should be read literally and that the determination should be based on the facts and circumstances.
If an equity investment participates significantly in profits but not losses, or vice versa, this criterion has not been met. In general, we believe that if the equity investment participates in the profits and losses in proportion to its overall ownership interest in the entity, the equity investment participates significantly in the profits and losses of the entity. For example, assume a general partner has a 1% interest in a limited partnership and participates on a pro rata basis in the limited partnership’s profits and losses. Although the interest is only 1%, it participates on a pro rata basis and would be deemed to participate significantly in the partnership’s profits and losses.

Even if an equity investment does not participate in the entity’s losses on a pro rata basis (e.g., preferred stock), it generally participates significantly in losses for this criterion if it is subject to total loss. An equity investment that is subject to only partial loss should be evaluated to determine whether the potential loss is significant when compared with the initial investment. For example, assume Company A and Company B form an entity and each contribute assets in exchange for an equity investment in the entity. Company A has the right to sell its equity investment to Company B at a future date for an amount equal to the fair value of the equity investment at the date of the entity’s formation. In this example, Company A’s equity investment does not participate significantly in the entity’s losses because if such losses were to occur, Company A could put its interest to Company B at the price it paid for the instrument. (The fact that Company B may be unable to perform in accordance with its contractual commitment is not considered in evaluating whether this criterion has been met.)

A reporting entity that concludes that an equity investment significantly participates in the entity’s losses must still determine whether the equity investment at risk participates significantly in the entity’s profits. We believe this determination should be made after considering the relative size of the investment and the potential for participation in profits. Using the previous example, assume instead that Company B has the right to call Company A’s equity investment in one year at a price equal to 105% of the price that Company A paid for the interest. In this example, Company A’s interest may not participate significantly in the entity’s profits because it can be called by Company B at only 5% above what Company A paid for the interest. (The fact that Company B may be unable to perform in accordance with its contractual commitment is not considered in evaluating whether this criterion has been met.)

Judgment is required to determine whether a potential loss in value or participation in the entity’s profits is significant. The determination takes into account all facts and circumstances, including the entity’s purpose and design, the nature of the instrument (e.g., preferred or common stock), the size of the potential losses relative to the interest’s fair value when acquired, and the nature of the entity’s assets, among other items.

**Question 7.4** Does preferred stock participate significantly in profits?

Determining whether preferred stock participates significantly in profits is based on facts and circumstances and requires the use of professional judgment. We believe the coupon should be evaluated to determine whether it permits significant participation in the entity’s profits. If the fixed coupon of a preferred stock provides a debt-like return, the preferred stock would not be considered an equity investment at risk. However, if the return is equity-like, it would participate significantly in the entity’s profits.

For example, if the entity’s operations are expected to generate a total return of 15% on amounts invested, and a preferred investor is entitled to a 10% yield on its investment, that return generally would participate significantly in profits. If the total return is anticipated to be 40%, and a preferred investor is entitled to a yield of only 6% on its investment, that return generally would be more characteristic of a debt-like return and would not participate significantly in profits.
7.2.2.2 Equity interests that were issued by the entity in exchange for subordinated interests in other VIEs

The entity does not have enough equity to finance its activities without additional subordinated financial support.

The equity holders, as a group, lack the characteristics of a controlling financial interest.

The entity is structured with non-substantive voting rights (i.e., anti-abuse clause).

- When determining whether an entity has sufficient equity, only GAAP equity that is at risk should be considered.

**Equity “at risk”:**
- Includes only equity investments in the entity that participate significantly in both profits and losses. If an equity interest participates significantly in only profits or only losses, the equity is not at risk.
- Excludes equity interests that were issued by the entity in exchange for subordinated interests in other VIEs.
- Excludes amounts (e.g., fees, charitable contributions) provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity.
- Excludes amounts financed for the equity holder (e.g., by loans or guarantees of loans) directly by the entity or by other parties involved with the entity.

An equity investment at risk excludes equity interests that were issued by the entity in exchange for subordinated interests in other VIEs. This criterion is intended to prevent multiple VIEs from being capitalized with one investment.

**Illustration 7-1: Equity investment exchanged for a subordinated interest in another VIE**

A reporting entity makes an equity investment of $10 million in a VIE. It forms a second entity and contributes the investment in the first VIE in exchange for all of the second entity’s equity interests.

**Analysis**

In this example, the $10 million equity investment in the second entity is not at risk because it has been issued in exchange for a subordinated interest in a VIE. Accordingly, the second entity is a VIE because it has no equity investment at risk.

7.2.2.3 Amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity

The entity does not have enough equity to finance its activities without additional subordinated financial support.

The equity holders, as a group, lack the characteristics of a controlling financial interest.

The entity is structured with non-substantive voting rights (i.e., anti-abuse clause).

- When determining whether an entity has sufficient equity, only GAAP equity that is at risk should be considered.

**Equity “at risk”:**
- Includes only equity investments in the entity that participate significantly in both profits and losses. If an equity interest participates significantly in only profits or only losses, the equity is not at risk.
- Excludes equity interests that were issued by the entity in exchange for subordinated interests in other VIEs.
- Excludes amounts (e.g., fees, charitable contributions) provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity.
- Excludes amounts financed for the equity holder (e.g., by loans or guarantees of loans) directly by the entity or by other parties involved with the entity.
An equity investment at risk excludes amounts (e.g., fees, charitable contributions, other payments) provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity. For example, in a lease transaction, fees such as structuring or administrative fees paid by the lessee to the owners of an entity are considered a return of the owner’s equity investment at risk when evaluating the sufficiency of equity in the entity.

However, this criterion is not violated if the provider is a parent, subsidiary or affiliate of the investor and is required to be included in the same set of consolidated financial statements as the investor.

Illustration 7-2: Amounts provided by the entity or others involved with the entity

Realco, a real estate developer, forms a limited partnership with Investco, a third-party investment company. Realco contributes $5 million to the partnership in exchange for a 5% general partnership interest. Investco contributes $95 million in exchange for a 95% limited partnership interest. At its inception, the partnership acquires a plot of land for the development of commercial real estate for $95 million. As compensation for certain efforts related to the identification and acquisition of the land and structuring of the partnership, Investco pays a $5 million fee to Realco.

Analysis

Realco’s equity investment in the partnership is not at risk because the fees received from Investco must be netted against its investment in the partnership. Therefore, Realco’s $5 million equity investment is not included in determining whether the limited partnership’s equity is sufficient for the entity to finance its activities without additional subordinated financial support.

We believe that all fees received by an equity investor at inception of an entity should reduce the equity investor’s equity interest when applying ASC 810-10-15-14(a). In addition, we believe that any fees an equity investor is unconditionally entitled to receive at inception of the entity also should reduce the investor's equity investment, even if those fees are received at a future date. In such cases, we believe the present value of these fees should be deducted from the investor’s equity investment at risk. However, if receipt of the fees is contingent upon the entity’s achievement of certain performance targets, and these contingencies are substantive (i.e., introduce a substantial risk that the investor will not receive the fees), the fees should not reduce the investor’s equity interest. Determining whether contingencies are substantive should be based on the facts and circumstances and requires the use of professional judgment.

We believe fees received by an equity investor for services provided after the formation of an entity do not reduce the investor’s equity investment at risk, as long as the fee is received in connection with the provision of a bona fide service, is consistent with market rates and is commensurate with the service provided. Fees received for services in excess of market rates represent a return of the investor’s equity interest. Determining whether fees are consistent with market rates is based on the facts and circumstances and requires the use of professional judgment.

Illustration 7-3: Fees received by an equity investor

A real estate developer forms a limited partnership to develop commercial real estate. Independent investors contribute equity of $950,000 in exchange for 95% limited partnership interests, and this equity is assumed to be at risk. The real estate developer contributes equity of $50,000 in exchange for a 5% general partnership interest. When the limited partnership is formed, the developer is paid a development fee of $20,000. The developer also is guaranteed a $10,500 payment on the entity’s first anniversary (the present value of which is $10,000). The developer also may receive an additional $30,000 fee if the entity realizes an internal rate of return (IRR) of greater than 15% over five years. It is not probable that the entity will achieve such a return.
The developer also will serve as the property manager for the real estate owned by the partnership. In this role, it will make decisions about the selection of tenants, lease terms, rental rates, capital expenditures, and repairs and maintenance, among other things. For these services, it will receive fees of $150,000 per year, which are commensurate with market rates for such services.

Analysis

At inception of the entity, the developer has an equity investment at risk of $20,000 (the $50,000 it contributed, less the $20,000 development fee it received and the $10,000 present value of the $10,500 payment it will receive on the entity's first anniversary). The developer's equity investment is not reduced by the additional $30,000 it may receive if the entity realizes an IRR in excess of 15% over five years because there is substantial uncertainty about whether such returns will be realized. The fees that the developer will receive for managing the property also do not reduce its equity investment because these are payments for the provisions of substantive services and reflect a market rate for such services.

Therefore, the limited partnership's total equity investment at risk is $970,000 (the independent investors' equity investment of $950,000 plus the developer's equity investment of $20,000).

Question 7.5 Are equity interests provided in exchange for services provided or to be provided (commonly referred to as sweat equity) considered equity investments at risk?

We do not believe that equity interests provided in exchange for services represent equity investments at risk because the entity has provided the investor's equity investment as compensation for the services provided, which violates ASC 810-10-15-14(a)(3).

Illustration 7-4: Sweat equity

Two oil and gas exploration companies, Oilco and Gasco, form an entity and contribute certain proven and unproven oil- and gas-producing properties. The two companies agree to provide an interest in the entity to an oilfield services company, Drillco, in exchange for engineering and drilling services it will provide to the partnership. At formation of the entity, the entity's fair value is $100 million. The expected losses of the entity are $70 million. The equity interests and related fair values of those interests at formation of the entity are as follows:

<table>
<thead>
<tr>
<th>Ownership %</th>
<th>Fair value ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oilco</td>
<td>33.3%</td>
</tr>
<tr>
<td>Gasco</td>
<td>33.3%</td>
</tr>
<tr>
<td>Drillco</td>
<td>33.3%</td>
</tr>
</tbody>
</table>

Analysis

The entity's equity investment at risk is $66.6 million (the sum of the equity investments of Oilco and Gasco). Drillco's equity investment is not at risk because it represents compensation for services Drillco will provide to the partnership. Accordingly, the partnership is a VIE because its equity investment at risk ($66.6 million) is insufficient to absorb its expected losses ($70 million).
Question 7.6

Are equity interests provided in exchange for the contribution of an intangible asset considered equity investments at risk?

We generally believe that equity interests provided in exchange for an intangible asset that meets the criteria for the recognition as an asset separate from goodwill pursuant to the provisions of ASC 805 may be considered equity investments at risk.

Illustration 7-5: Equity investment received from the contribution of an intangible asset

Two software companies form a partnership. Each company contributes software that it has internally developed for licensing to third parties and $2 million of cash in exchange for equity interests in the partnership. The software products of each partner, which have complementary functionality, will be integrated into one product for licensing to third parties. Each software product meets the criteria for an identifiable intangible asset that could be accounted for separately from goodwill in a business combination pursuant to ASC 805. The carrying amount of each partner’s software product prior to contribution is minimal. The fair value of each software product contributed is approximately $20 million.

Analysis

The partnership’s equity investment at risk is $44 million, which is the sum of the cash contributed by the partners ($2 million each) plus the fair value of the contributed software ($20 million each).

Question 7.7

Assume a holder of an equity investment at risk writes a call option on that equity investment to another variable interest holder. Is the investor’s equity investment considered to be at risk?

We believe that the option premium generally should not reduce the amount of the investor’s equity investment at risk if (1) the call option’s strike price is sufficiently out of the money and (2) the option’s premium is at fair value. Both conditions must be met to conclude that the option premium should not reduce the investor’s equity investment at risk, because while an option premium may be at fair value, it could include a financing element. Consider the following two options:

<table>
<thead>
<tr>
<th></th>
<th>Option 1</th>
<th>Option 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset value</td>
<td>$ 100</td>
<td>$ 100</td>
</tr>
<tr>
<td>Option’s strike price</td>
<td>$ 130</td>
<td>$ 80</td>
</tr>
<tr>
<td>Option’s fair value (assumed)</td>
<td>$ 15</td>
<td>$ 35</td>
</tr>
</tbody>
</table>

Option 1’s strike price is sufficiently out of the money at its inception and its premium is assumed to be at fair value. Therefore, we believe the equity investor that wrote Option 1 should not reduce its equity investment at risk.

Option 2’s premium is at fair value, but it includes a financing element of $20 for the amount that the option is in the money at its inception. Consequently, we believe the equity investor that wrote Option 2 should reduce its equity investment at risk by at least $20 (the facts and circumstances may indicate a higher amount may be warranted). Such a reduction could affect the sufficiency of equity test.

Another consequence of such a reduction is that the entity may be a VIE because a portion of the investor’s equity investment that is not at risk may absorb the entity’s expected losses, thus violating the requirement that an entity’s equity investment at risk absorb the first dollar risk of loss (see Section 7.3.2). All facts and circumstances should be considered in determining whether a portion of an investor’s equity investment is at risk, particularly when other transactions among the variable interest holders have occurred.
7.2.2.4 Amounts financed for the equity holder directly by the entity or by other parties involved with the entity

The entity does not have enough equity to finance its activities without additional subordinated financial support.

The equity holders, as a group, lack the characteristics of a controlling financial interest.

The entity is structured with non-substantive voting rights (i.e., anti-abuse clause).

- When determining whether an entity has sufficient equity, only GAAP equity that is at risk should be considered.

**Equity “at risk”:**

- Includes only equity investments in the entity that participate significantly in both profits and losses. If an equity interest participates significantly in only profits or only losses, the equity is not at risk.
- Excludes equity interests that were issued by the entity in exchange for subordinated interests in other VIEs.
- Excludes amounts (e.g., fees, charitable contributions) provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity.
- Excludes amounts financed for the equity holder (e.g., by loans or guarantees of loans) directly by the entity or by other parties involved with the entity.

The Variable Interest Model does not permit an equity investment at risk to be financed (e.g., by loans or guarantees of loans) directly by the entity or by parties involved with the entity. For example, a stock subscription receivable is not considered an equity investment at risk. However, this criterion is not violated if the financing comes from 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.

We believe that an equity holder may finance its equity investment or enter into other risk management arrangements provided such arrangements are with parties that have no involvement with the entity. When the equity investment at risk is financed in a structured transaction, the terms of the arrangement should be evaluated carefully to ensure that the equity investor is not acting as an agent for another party (e.g., the principal lender, guarantor). If the investor is acting as an agent, the equity interest should be attributed to the principal, not the investor.

Factors that may indicate that the equity investor is acting as an agent on behalf of another variable interest holder in the entity include:

- The investor has previously acted as an agent of the lender.
- Substantially all returns (both profits and losses) inuring to the equity investor are passed through the investor to the lender.

**Illustration 7-6: Equity investment financed with nonrecourse debt by independent party**

Leaseco forms an LLC to construct a $100 million commercial office building in a build-to-suit arrangement and leases it to Company A. Leaseco funds the LLC with equity of $20 million, and the LLC borrows an additional $80 million from Bank A. Leaseco finances its entire equity investment in the LLC with Bank B, an independent financier. Bank B has recourse only to Leaseco’s investment in the LLC and not the general credit of Leaseco.

**Analysis**

Leaseco’s $20 million equity investment is considered to be at risk. Although Leaseco has financed its entire equity investment with nonrecourse debt, it has done so with a party not involved with the LLC.
**Illustration 7-7: Equity investment financed with nonrecourse debt by party involved with the entity**

Assume the same facts as in Illustration 7-6, except that Leaseco finances $10 million of its equity investment in the LLC with Bank B and $10 million of its investment with an equity investee of Bank A, each on a nonrecourse basis.

**Analysis**

Because half of Leaseco’s $20 million equity investment has been financed by a related party of Bank A, which is a variable interest holder in the LLC, that portion of the investment is not considered to be at risk. Therefore, $10 million of equity is considered to be at risk when determining the sufficiency of equity.

As stated in ASC 810-10-15-14(a)(3) and (4), the total equity investment at risk does not include amounts provided to or financed for the equity investor directly by the legal entity or by other parties involved with the legal entity [emphasis added].

Therefore, we believe a reporting entity should consider transactions or relationships that it has with an entity or with other parties involved with the entity to determine not only whether the equity investment is at risk, but also to identify the parties holding variable interests in the entity and the entity’s primary beneficiary. Because the Variable Interest Model does not contemplate all potential types of structuring, the use of professional judgment is required.

The SEC staff shares this view, as discussed in a speech\(^\text{18}\) in which the staff expressed that activities around the entity such as equity investments between investors, puts and calls between the reporting entity and other investors and non-investors, service arrangements with investors and non-investors, and derivatives such as total return swaps should be considered when applying the VIE model. While this speech was intended to address accounting under FIN 46(R), we believe that the concepts remain relevant.

---

7 Determining whether an entity is a VIE

Illustration 7-9: Transactions outside the entity

Now assume Manufacturer X sells a product to Entity 1 for $100. Entity 1 was capitalized by issuing equity ($10) and debt ($90) to Investor and Lender, respectively. Manufacturer X writes a fixed price put option so that Investor (instead of Entity 1) may put the equity to Manufacturer X for $10 at a future date. The transaction is illustrated as follows:

Analysis

We believe the equity investment in this structure would not be at risk and the entity would be a VIE because the substance of the guarantee (provided by a party involved with Entity 1) prevents the equity provider from being exposed to potential losses of Entity 1. We do not believe that a transaction between two parties may be ignored merely because the entity under evaluation (i.e., Entity 1) is not a direct party to the transaction.

7.2.2.5 Other examples of determining equity investments at risk

The following examples describe how to determine whether equity investments are at risk based on the factors described in ASC 810-10-15-14(a).

Illustration 7-10: Determining equity investments at risk

Example 1

Company B and Developer C form LandDevelopers, Inc., to buy undeveloped land, develop it and sell it to unrelated homebuilders. Each entity contributes $5 million in exchange for all of the common stock of the corporation. Profits, losses and decision making are shared pro rata. LandDevelopers, Inc., purchases undeveloped property for $40 million that was funded by the equity contributions, $20 million of nonrecourse debt and $12 million of non-voting cumulative preferred stock bearing a fixed coupon of 5% that is puttable at 95% of par in five years. Developer C receives $2 million in development fees at the entity’s inception.

Analysis

The total amount of equity at risk is $8 million. The $8 million comprises $5 million from Company B and $3 million from Developer C.

The $2 million of Developer C’s investment does not meet the criteria to be considered at risk because Developer C received that amount in fees from the entity at inception (see Section 7.2.2.3). The preferred stock investment would not be considered at risk because the put right held by the preferred investor prevents it from participating significantly in the entity’s losses. The 5% coupon, meanwhile, does not participate significantly in profits (see Section 7.2.2.1).
**Example 2**

Assume the same facts as Example 1 except that instead of receiving a $2 million fee at inception, Developer C receives only $1 million at inception. However, Developer C is unconditionally entitled to receive an additional $1 million at the end of two years.

**Analysis**

The timing of Developer C’s receipt of the fees does not affect the assessment of whether the equity is at risk. Accordingly, the $1 million fee it receives at inception and the present value of the $1 million fee to be paid at the end of two years reduces the equity investment at risk.

If the deferred development fees were contingent on the entity’s performance or other factors, they might not reduce the Developer’s equity investment. The determination as to whether the contingency is substantive should be based on the facts and circumstances.

**Example 3**

Assume the same facts as Example 1 except that the preferred stock is not puttable or cumulative and bears a fixed coupon of 12%.

**Analysis**

In this case, at-risk equity is $20 million. The $20 million includes $5 million from Company B’s investment, $3 million from Developer C’s investment and $12 million for the preferred stock investment. The preferred stock is included because it will likely participate significantly in the profits of the entity because of the relatively higher rate of return (assuming that the 12% return represents a significant portion of the entity’s GAAP profits), and, without the put, a significant portion of the investment could be lost if the entity were to incur losses.

---

**Illustration 7-11: Determining equity investments at risk**

**Example 1**

ABC Enterprises and Investor XYZ form a limited partnership to buy and sell ownership interests in real estate. ABC Enterprises serves as general partner and contributes $100 million of existing subordinated investments in other real estate entities that are VIEs to the partnership. Investor XYZ contributes $100 million in exchange for the sole limited partnership interest. The partnership has no debt.

Partnership losses are shared on a pro rata basis. However, to compensate ABC Enterprises for its duties as general partner, profits are shared pro rata until Investor XYZ has reached an internal rate of return on its investment of 15%. At that point, ABC Enterprises receives all of the profits.

**Example 2**

Assume the same facts as in Example 1, except that ABC Enterprises contributes $100 million of cash, and the real estate ownership interests are purchased in the open market from third parties. Also, assume that ABC Enterprises finances its investment on a nonrecourse basis with proceeds received from Bank A, which is not related to ABC Enterprises or Investor XYZ and is not involved with the limited partnership.

**Example 3**

Assume the same facts as in Example 2, except that Investor XYZ can put its limited partnership interest to ABC Enterprises for $100 million after five years.
## Analysis

<table>
<thead>
<tr>
<th>At-risk factor</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Do the equity holders significantly participate in profits and losses of the entity?</td>
<td>Possibly. As long as the 15% internal rate of return to Investor XYZ makes up a significant amount of the entity's expected GAAP profits, Investor XYZ's equity interest would significantly participate in profits and losses. ABC's equity investment significantly participates in profits and losses.</td>
<td>Possibly. See Example 1.</td>
<td>No. Investor XYZ does not participate significantly in the losses of the partnership due to the existence of the put option. The put option protects Investor XYZ from all future losses. Accordingly, the equity investment is not at risk.</td>
</tr>
<tr>
<td>2. Does equity include equity interests issued in exchange for subordinated interests in other VIEs?</td>
<td>Yes. ABC Enterprises' equity investment meets this criterion. Accordingly, its equity investment is not at risk.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td>3. Has any amount of equity been provided to the equity investor directly by the entity or by other parties involved with the entity?</td>
<td>No.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td>4. Has any amount of equity been financed directly by the entity or by other parties involved with the entity?</td>
<td>No.</td>
<td>No. Although ABC Enterprises financed its equity investment on a nonrecourse basis with Bank A, Bank A has no involvement with the entity. However, it should be noted that if ABC Enterprises were acting in the capacity of an agent for Bank A, Bank A may need to evaluate the entity for consolidation.</td>
<td>No. See Example 2</td>
</tr>
<tr>
<td>5. Conclusion</td>
<td>Only Investor XYZ's $100 million equity investment is at risk. Therefore, this amount should be evaluated to determine whether it is sufficient for the partnership to finance its activities.</td>
<td>The total equity investment of $200 million is at risk. Therefore, this amount should be evaluated to determine whether it is sufficient for the partnership to finance its activities.</td>
<td>Only ABC Enterprise's $100 million equity investment is at risk. Therefore, this amount should be evaluated to determine whether it is sufficient for the partnership to finance its activities.</td>
</tr>
</tbody>
</table>

### 7.2.3 Methods for determining whether an equity investment at risk is sufficient

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Recognition — Variable Interest Entities**

**810-10-25-45**

An equity investment at risk of less than 10 percent of the legal entity's total assets shall not be considered sufficient to permit the legal entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient. The demonstration that equity is sufficient may be based on either qualitative analysis or quantitative analysis or a combination of both. Qualitative assessments, including, but not limited to, the qualitative assessments described in (a) and (b), will in some cases be conclusive in determining that the legal entity's equity at risk is sufficient. If, after diligent effort, a reasonable conclusion about the sufficiency of the legal entity's equity at risk cannot be reached 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.

810-10-25-46
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.

810-10-25-47
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.

Once a reporting entity determines the amount of GAAP equity that is at risk, the reporting entity must determine whether that amount of equity is sufficient for the entity to finance its activities without additional subordinated financial support. This can be demonstrated in one of three ways: (1) by demonstrating that the entity has the ability to finance its activities without additional subordinated financial support; (2) by having at least as much equity as a similar entity that finances its operations with no additional subordinated financial support; or (3) by comparing the entity’s at-risk equity investment with its calculated expected losses.

Often, the determination of the sufficiency of equity is qualitative. In certain circumstances, a reporting entity may be required to perform a quantitative analysis.

7.2.3.1 10% test — a misnomer
Because precisely estimating expected losses may be difficult, the FASB established a presumption that an equity investment is insufficient to allow an entity to finance its activities unless the investment equals at least 10% of the fair value of the entity’s total assets. We believe that the FASB’s intent was to emphasize that the 3% equity presumption that existed before the development of the Variable Interest Model was superseded.
The 10% presumption applies only in one direction. That is, an equity investment of less than 10% is presumed to be insufficient, but an equity investment of 10% or more is not presumed to be sufficient. Because the Variable Interest Model specifies that an equity investment of less than 10% is presumed to be insufficient (unless the equity investment can be demonstrated to be sufficient) and an equity investment of 10% or greater does not relieve a reporting entity of its responsibility to determine whether an entity requires a greater equity investment, we do not believe that the 10% presumption is relevant. We therefore believe it should not be used in making the determination of whether the equity investment at risk is sufficient. Instead, we believe that the sufficiency of an entity’s equity investment at risk must be demonstrated in all cases through one of the three methods specified in ASC 810-10-25-45.

7.2.3.2 The entity can finance its activities without additional subordinated financial support

A reporting entity can demonstrate that the amount of equity in an entity is sufficient by evaluating whether the entity has enough equity to induce lenders or other investors to provide the funds necessary at market terms for the entity to conduct its activities. For example, recourse financing or a guarantee on an entity’s debt is a qualitative factor that indicates an entity may not have sufficient equity to finance its activities without additional subordinated financial support. The determination of whether an entity investment at risk is sufficient should be made after consideration of all facts and circumstances.

Illustration 7-12: Demonstrating whether the amount of equity is sufficient

Consider a real estate partnership that operates a property. The partnership’s initial equity investment is 30% of the asset’s value. If the partnership were able to obtain market rate, nonrecourse financing for 70% of the property’s value, we generally believe that the entity would be able to demonstrate that it can finance its activities without additional financial support.

If, however, the entity were able to obtain nonrecourse financing for only 60% of the property’s value, and the partnership obtained subordinated financing from a separate lender for 10% of the property’s value, we do not believe that the entity would have demonstrated that it has sufficient equity to finance its activities without additional financial support. That is, because the partnership was required to issue subordinated debt to obtain the senior financing, it would be difficult to assert that the equity is sufficient to absorb all of the partnership’s expected losses. The entity could then try to demonstrate that the equity is sufficient by looking for a comparable entity that is financed with at least the same amount of equity (30% in this example) and operates with no additional subordinated financial support (see Section 7.2.3.3). If such an entity cannot be identified, the partnership’s expected losses could be calculated based on reasonable quantitative evidence and compared with the amount of the equity investment at risk to demonstrate whether the equity is sufficient (see Section 7.2.3.4).

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

We believe that a reporting entity can demonstrate the sufficiency of an entity’s equity investment at risk by reference only to unaffiliated entities that have substantially similar operations and economic characteristics.

To determine whether an entity has substantially similar operations and economic characteristics and therefore can be used for comparison purposes in this test, reporting entities should look at characteristics including the following:

- Size and composition of assets
- Amount
Question 7.8 Is a bank or insurance company deemed to have sufficient equity because it is required by regulation to maintain minimum levels of capital to operate?

We generally believe that meeting the minimum capital requirements imposed by a regulator may be used to assist in determining the sufficiency of the equity investment at risk in a financial institution such as a bank or insurance company. We understand that the FASB decided not to require an equity investment of at least 10% of assets in all cases partly because of regulatory requirements that allow financial institutions to operate at capital levels that are less than 10% of their total assets (see Section 7.2.3.1).
7.2.3.4 The amount of equity invested in the entity exceeds the estimate of the entity’s expected losses based on reasonable quantitative evidence

In certain circumstances, a reporting entity may be required to perform a quantitative analysis. The Variable Interest Model uses expected losses as the benchmark to determine whether the equity at risk is sufficient to finance the entity without additional subordinated financial support. If the equity investment at risk is insufficient to absorb expected losses, the entity is a VIE. An entity’s expected losses are not GAAP or economic losses expected to be incurred by an entity, and expected residual returns are not GAAP or economic income expected to be earned by an entity. Rather, these amounts are derived using projected cash flow techniques described in CON 7, which requires a reporting entity to project multiple outcomes for an entity based on different scenarios and assign a probability weight to each outcome. The multiple outcomes should be based on projections of possible economic outcomes under different scenarios. The scenarios are based on varying the key assumptions that affect the entity’s results of operations or the fair value of its assets and result in changes to the returns available to the entity’s variable interest holders. The calculation of expected losses and expected returns may require the assistance of valuation professionals. The calculation is described in Appendix A of this publication.

It is important to note that even an entity that expects to be profitable will have expected losses. Expected losses are based on the variability in the fair value of the entity’s net assets, exclusive of variable interests, and not on the anticipated variability of net income or loss. Accordingly, even an entity that has a history of profitability and expects to remain profitable may be a VIE if its equity investment at risk is insufficient to absorb its expected losses (i.e., the probability-weighted potential unfavorable variability may be greater than the equity investment at risk). See Chapter 5 and Appendix A for further guidance on the calculation of expected losses.

A qualitative assessment is often used to demonstrate whether an entity’s equity investment at risk is sufficient either with evidence that the entity can obtain financing without additional subordinated financial support or by reference to the equity invested in another similar entity as described in Sections 7.2.3.2 and 7.2.3.3, respectively. In some circumstances, such as when an entity has a complex capital structure, it may be difficult to use either of these methods to demonstrate that the entity can finance its activities without additional subordinated financial support. That is, an entity capitalized with multiple classes of debt with different priorities may be unable to qualitatively demonstrate it can finance its activities without additional subordinated financial support because it generally would be unclear that the equity investment at risk is sufficient to absorb the entity’s expected losses. In these circumstances, we believe reporting entities may apply a quantitative approach.

Question 7.9  May other investments made by equity owners be considered an equity investment at risk when determining the sufficiency of an entity’s equity at risk?

ASC 810-10-15-14(a) states that the equity investment at risk must be an interest reported as equity in that entity’s GAAP financial statements. Accordingly, we do not believe that investments made by an equity holder that are not reported as equity in the entity’s financial statements can be considered equity at risk.
Illustration 7-13: Other investments made by equity owners

Assume an entity's capital structure consists of subordinated debt of $5 that was loaned by an equity holder and an equity investment at risk of $7.

Analysis

If the expected losses were determined to be less than $7 based on reasonable quantitative evidence, the equity would be deemed to be sufficient to permit the entity to finance its activities without additional financial support. However, if expected losses were determined to be greater than $7, the equity investment at risk would be deemed insufficient because the subordinated debt would absorb some of the entity's expected losses. Even though the subordinated debt was provided by an equity owner, the form of the instrument is determinative. The equity investment at risk can include only interests reported as equity in the entity's GAAP financial statements, regardless of their source (see Section 7.2.1).

Question 7.10

For purposes of determining the sufficiency of the equity investment at risk, should sufficiency be measured based on the carrying amount of the entity's equity, as reported in its GAAP balance sheet, or the fair value of the equity interests?

We believe the fair value (as defined by ASC 820) of the equity investment at risk as of the date the evaluation is performed should be used in evaluating the sufficiency of the equity investment at risk. At the date of formation, the fair value and carrying amount of the equity investments often will be the same, excluding transaction costs. However, the fair value of the equity investment generally will differ from its carrying amount at dates after the entity's formation, and the fair value should be used in the analysis if a VIE reconsideration event occurs.

7.2.3.5 Illustrative examples

The following illustrates the application of the provisions of ASC 810-10-25-45 and 25-46. Assume that the business scope exception to the Variable Interest Model does not apply:

Illustration 7-14: Qualitative and quantitative analyses of sufficiency of equity at risk

Example 1

DAX Partners is a partnership formed by two brothers in the business of harvesting wheat and hauling hay for farmers in the Midwest. The balance sheet of DAX Partners at its formation is as follows:

<table>
<thead>
<tr>
<th>Total assets</th>
<th>$12.0 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank loan</td>
<td>9.0 million</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>1.9 million</td>
</tr>
<tr>
<td>Partners’ capital</td>
<td>1.1 million</td>
</tr>
</tbody>
</table>

Of the bank loan, $7.5 million bears a fixed interest rate of 6%, is due in five years and is secured only by combines, hay hauling and other equipment. Therefore, the bank has no recourse to the equity holders.

The remaining $1.5 million of the bank loan is unsecured, bears a fixed interest rate of 8%, is guaranteed by the partners and is due in seven years.

Older Brother contributed $600,000 and Younger Brother contributed $500,000 in exchange for equity interests. Although the brothers have equal voting control, they share profits and losses in accordance with their respective capital contributions.

DAX Partners is unable to demonstrate the sufficiency of its equity investment at risk by comparison to another entity (i.e., through ASC 810-10-25-45(b)).
Analysis

Because DAX Partners is unable to demonstrate the sufficiency of its equity investment at risk by comparison with another entity, it can attempt to qualitatively demonstrate whether the equity is sufficient or perform an expected loss calculation. The partners’ guarantee on the unsecured loan may provide qualitative evidence that DAX Partners’ equity investment at risk is not sufficient for the entity to finance its activities without additional subordinated financial support. However, if it is still unclear after evaluating qualitative evidence, an expected loss calculation would be required to demonstrate whether or not the partners’ capital exceeds expected losses. Note that comparing the relative size of the equity investment with the entity’s assets is not determinative (i.e., it cannot be presumed that the equity investment at risk is sufficient even if it were greater than 10% of assets).

In this situation, if the partners did not guarantee the unsecured debt and it bore a reasonable interest rate, DAX Partners might be able to demonstrate that it has sufficient equity to finance its activities without additional subordinated financial support.

Example 2

Assume the same facts as in Example 1, except the $1.5 million unsecured loan is not guaranteed by the partners, bears a fixed interest rate of 12%, is due in 10 years and is entitled to 30% of all GAAP profits above a stated threshold.

Analysis

DAX Partners may be able to qualitatively evaluate whether the equity is sufficient. The unsecured loan has characteristics of an “equity-like return,” calling into question the sufficiency of the partners’ capital. Without the partners’ guarantee of repayment, the subordinated investor demanded a higher interest rate along with a significant participation in GAAP profits, qualitatively indicating that DAX Partners may not have sufficient equity to support itself without additional subordinated financial support. If DAX Partners cannot qualitatively determine whether or not the equity investment at risk is sufficient, an expected loss calculation is required.

Example 3

Assume the same facts as in Example 2 except that the entity’s expected losses are computed to be $1 million. Allocation of the entity’s expected losses indicates that in certain possible outcomes of the entity, both the equity investment at risk and the subordinated debt will absorb expected losses.

Analysis

In this fact pattern, expected losses ($1 million) are less than the partners’ capital ($1.1 million). Accordingly, the equity of the partnership would be considered sufficient even though there are certain possible outcomes that would show expected losses inuring to the subordinated debt holder.

Expected losses are based on a probability-weighted distribution of all possible outcomes. The Variable Interest Model requires the amount of equity at risk to exceed only expected losses of the entity as a whole. It does not require the equity to be sufficient to bear all losses that could occur in each possible outcome (see Appendix A).
Illustration 7-15: Fees received by an equity investor — sufficiency of equity at risk

Company A and Developer B form a partnership by contributing $80 and $20, respectively, and have voting and economic interests of 80% and 20%, respectively. The partnership purchased undeveloped property for $1,000 that was funded by partner contributions, $600 of nonrecourse debt and $325 of unsecured debt. Developer B receives a development fee of $25 from the partnership at inception of the entity. Company A and Developer B calculate expected losses to be $85 based on reasonable quantitative evidence.

Analysis

The partnership is a VIE because it does not have sufficient equity at risk to permit it to absorb its expected losses. Developer B does not have an equity investment at risk because the development fee it received at inception of the entity eliminates its equity investment of $20. Accordingly, the partnership's equity investment at risk ($80) is less than expected losses ($85). See Section 7.2.2.3 for additional guidance on fees received by an equity investor.

7.2.4 Development stage entities

In June 2014, the FASB issued ASU 2014-10, which eliminated the definition of a development stage entity and the financial reporting requirements specific to development stage entities. The amendments also eliminated an exception that previously existed in ASC 810 for determining whether a development stage entity had sufficient equity at risk and therefore was a variable interest entity (VIE). As a result of this amendment, more entities could be VIEs.

The amendments in ASU 2014-10 to the consolidation guidance are effective for public business entities19 for annual periods beginning after 15 December 2015, and interim periods therein. For other entities, it is effective for annual periods beginning after 15 December 2016 and for interim periods beginning after 15 December 2017. Retrospective application is required and early adoption is permitted.

7.3 The equity holders, as a group, lack the characteristics of a controlling financial interest

For an entity not to be a VIE, the at-risk equity holders, as a group, must have all of the following characteristics of a controlling financial interest:

- The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance (see Section 7.3.1)
- The obligation to absorb an entity’s expected losses (see Section 7.3.2)
- The right to receive an entity’s expected residual returns (see Section 7.3.3)

---

19 ASU 2013-12, Definition of a Public Business Entity, defined a public business entity.
7.3.1 The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance

- For an entity not to be a VIE, the at-risk equity holders (as a group) must have all of the following characteristics:
  - 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:
    - Corporations and similar entities
    - Limited partnerships and similar entities
  - The obligation to absorb an entity’s expected losses
  - The right to receive an entity’s expected residual returns

Excerpt from Accounting Standards Codification

Consolidation – Overall
Scope and Scope Exceptions – Variable Interest Entities
810-10-15-14
b. As a group the holders of the equity investment at risk lack any one of the following three characteristics:
  1. The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity’s economic performance
     i. For legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights (participating rights) as discussed in paragraphs 810-10-25-2 through 25-14 are not VIEs if the holders of the equity investment at risk as a group have the power to control the entity and the equity investment meets the other requirements of the Variable Interest Entities Subsections.

01. If no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly impact the entity’s economic performance, kick-out rights or participating rights (according to their VIE definitions) held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 810-10-55-37 through 55-38.
ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists. The guidance in this subparagraph does not apply to entities in industries (see paragraphs 910-810-45-1 and 932-810-45-1) in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14). [Content amended as shown and moved from paragraph 810-20-15-3(c)]

01. A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive kick-out rights (according to their voting interest entity definition) through voting interests over the general partner(s).

A. For purposes of evaluating the threshold in (01) above, a general partner’s kick-out rights held through voting interests shall not be included. Kick-out rights through voting interests held by entities under common control with the general partner or other parties acting on behalf of the general partner also shall not be included.

02. Limited partners with equity at risk are able to exercise substantive participating rights (according to their voting interest entity definition) over the general partner(s).

03. For purposes of (01) and (02) above, evaluation of the substantiveness of participating rights and kick-out rights shall be based on the guidance included in paragraphs 810-10-25-2 through 25-14C.

The owners of the equity investment at risk should be able to make decisions that most significantly affect the economic results of an entity. Otherwise, the entity is a VIE. This aspect of the Variable Interest Model is based on the premise that as the decisions to be made by the equity holders become less significant, a model that bases consolidation on ownership of voting interests becomes less relevant.

For the equity holders as a group to have power, they must have the ability, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance. While an entity’s operations may involve a number of activities, a subset of those activities is generally considered significant to the entity’s economic performance. A reporting entity should carefully evaluate the purpose and design of an entity to determine the entity’s significant activities. It helps to ask, “Why was this entity created?” and “What is the entity’s purpose?”

The following graphic illustrates how to think about the power assessment systematically:

```
Step 1
Consider purpose and design

Step 2
Identify the activities that most significantly impact economic performance

Step 3
Identify how decisions about the significant activities are made and the party or parties that make them
```
7.3.1.1 Step 1: Consider purpose and design

In evaluating the power criterion, a reporting entity first considers the purpose and design of the entity and the risks that the entity was designed to create and pass to its variable interest holders. In evaluating purpose and design, a reporting entity also considers the nature of the entity’s activities, including which parties participated significantly in the design or redesign of the entity, the terms of the contracts the entity entered into, the nature of interests issued and how the entity’s interests were marketed to potential investors. The entity’s governing documents, marketing materials, and contractual arrangements should be closely reviewed and combined with the analysis of the activities of the entity to determine which party or parties have power over an entity.

See Chapter 5 for further guidance on evaluating the purpose and design of an entity and the risks that an entity is designed to create and pass to its variable interest holders.

7.3.1.2 Step 2: Identify the activities that most significantly impact the entity’s economic performance

For an entity to be a voting interest entity, the holders of the equity investment at risk, as a group, must have the power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance (“power”). We believe the power held by the holders of the equity investment at risk, as a group, cannot be limited to administrative functions. Rather, power must enable these equity holders to make substantive decisions.

Decisions are substantive when they most significantly affect the economic performance of the entity (e.g., the entity’s revenues, expenses, margins, gains and losses, cash flows, financial position). Examples of substantive decisions that affect economic performance may include the ability to purchase or sell significant assets, enter into new lines of business, incur significant additional indebtedness, make acquisition and/or divestiture decisions or determine the strategic operating direction of the entity. We believe that the assessment of power in evaluating whether an entity is a VIE generally will be consistent with the assessment of power when determining the primary beneficiary of a VIE. That is, we believe that the activities a reporting entity identifies for determining whether the entity is a VIE will be the same activities that are identified when determining the primary beneficiary of a VIE (see Chapter 8).

Additionally, when considering all facts and circumstances, reporting entities would consider the extent to which the holders of an entity’s at-risk equity investment absorb expected losses and receive expected residual returns of the entity. Generally, the ability to make decisions that have a significant impact on the success of the entity becomes more important to the at-risk equity group as the amount of its investment increases. The greater the amount of the at-risk equity investment compared with the expected losses of the entity, the less likely it is that the holders of the investment would be willing to give up the ability to make decisions. Alternatively, if the total equity investment at risk is not sufficient to permit the entity to finance its activities, the parties providing the necessary additional subordinated financial support most likely will not permit an equity investor to make decisions.

Determining whether, as a group, the holders of the equity investment at risk have the power will be based on the facts and circumstances and will require the use of professional judgment.

7.3.1.3 Step 3: Identify how decisions about significant activities are made and the party or parties that make them

Once the activities that most significantly impact an entity’s economic performance have been identified, the next step is to identify how decisions about those activities are made and which party or parties make those decisions.
We believe that Step 1 and Step 2, as described above, apply to all entities regardless of their type (e.g., limited partnerships or corporation). However, the provisions of Step 3 are different depending on whether the entity being evaluated is corporation or similar entity (see Section 7.3.1.3.1) or a limited partnership or similar entity (see Section 7.3.1.3.2).

### 7.3.1.3.1 Corporations and similar entities

The application of Step 3 for corporations and similar entities is focused on determining whether the at-risk equity holders have power through their voting rights. We believe that when a reporting entity is performing this evaluation it would first evaluate substantive shareholders’ voting rights. In other words, substantive shareholder voting rights have primacy over the rights of others (e.g., rights provided in a service or management contract) and should be evaluated first in determining whether the at-risk shareholders have power through voting rights over the activities of an entity that most significantly impact the entity’s economic performance. This may be the case, for example, when the shareholders’ voting rights provide them with the power to elect the entity’s board of directors and the board is actively involved in making the decisions about the activities that most significantly impact the entity’s economic performance.

The FASB staff described this analysis in the Basis for Conclusions to ASU 2015-02:

> In redeliberations, the Board clarified that two steps are required to evaluate the condition in paragraph 810-10-15-14(b)(1)(i), which may be a change to practice. The Board observed that the first two sentences of paragraph 810-10-15-14(b)(1)(i), which discuss whether investors hold voting rights or similar rights (such as those of a common shareholder in a corporation), should be evaluated first in determining whether the equity holders 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. 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 the equity holders do not 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, the second step of the analysis must be performed to evaluate whether there is a decision maker that has that power through a contractual arrangement. In this case, the remaining language in paragraph 810-10-15-14(b)(1)(i), which indicates that kick-out rights or participating rights should be considered if a single holder can exercise such rights unilaterally, should be used to determine if an entity is a VIE... The amendments in this Update clarify the sequencing of the evaluation in paragraph 810-10-15-14(b)(1).

For an entity not to be a VIE, the power to direct each of the activities that most significantly impact the entity’s economic performance must come from the equity investment at risk. While the word “each” is not explicitly stated, we understand that this is how the FASB expects the guidance to be applied. Therefore, it is important to carefully identify all of the activities that most significantly impact an entity’s economic performance.

Other interests held by holders of an equity investment at risk may not be combined with equity interests in determining whether power is held by the holders of an entity’s equity investment at risk. This assessment will be based on the facts and circumstances and will require the use of professional judgment. The significant activities identified for one entity may not be significant to another entity.
### Illustration 7-16: Power through interests other than equity investments at risk

Entity A, Entity B and Entity C are unrelated parties that form a corporation to distribute a product to an unrelated third party. The three investors decide to hire a manager, Entity A, to make all significant decisions for the corporation through a management agreement. Each equity investor receives one seat on the entity’s board of directors, and all board decisions require a simple-majority vote of the three board members. The investors only have protective rights with respect to the decisions related to the activities that most significantly impact the entity’s economic performance. The removal of Entity A as the manager requires approval of the three board members.

**Analysis**

In this example, the power rests with Entity A by virtue of the management agreement, not its equity interest. Additionally, Entity A’s decision making ability is not constrained by any rights held by the equity holders. Therefore, the entity would be a VIE because there is no decision making embodied in the equity interests.

### Illustration 7-17: Power through equity investments at risk

In contrast to the structure in Illustration 7-16, assume Entity A makes all significant decisions for the entity pursuant to its equity investment. The equity holders agree to share the profits disproportionately within the equity group to compensate Entity A for service performed as the manager.

**Analysis**

Although economically the rights and obligations of the equity holders of both entities are the same as in Illustration 7-16. In this case, because the decision making for the entity is embodied in an equity interest, the entity is not a VIE (assuming that none of the other criteria are violated).

It is not necessary for all holders of an equity investment at risk to participate in decision making, as long as power is held by a member(s) of the at-risk equity group. Because this test is applied to the holders of the equity investment at risk as a group, if any member, or collection of members, of the group that holds a substantive equity investment has the power, through its equity position, to direct the activities of an entity that most significantly impact the entity’s economic performance, we generally believe that the criterion in ASC 810-10-15-14(b)(1)(i) is met. Determining whether a reporting entity has a substantive equity investment in an entity should be made based on all of the facts and circumstances and should consider the absolute size of the investment and its relationship to (1) the total equity investment at risk and (2) the entity’s total assets.

Sometimes, a corporation may outsource decision making about the activities that most significantly impact the entity’s economic performance through a management or similar agreement. In these situations, questions may arise about whether the equity holders still have power to direct the activities that most significantly impact the entity’s economic performance.
We believe that the equity holders, as a group, will have power if a single equity holder (including its related parties and de facto agents), equity holders with a simple majority of voting interests or equity holders with a smaller voting interest with equity at risk can remove or replace the decision maker or service provider. In other words, a substantive kick-out right held by these parties precludes the decision maker or service provider that makes the significant decisions from having power. For example, assume a non-equity holder believes it has the power to direct the activities that most significantly impact the entity’s economic performance such that it would appear that the entity may be a VIE. However, if equity holders with a simple majority of voting interests have the ability to remove or kick out the non-equity holder without cause, the legal entity would not be a VIE because the equity holders’ kick-outs right negates the non-equity holder’s decision-making ability. The entity would therefore be evaluated for consolidation under the Voting Model, assuming the other VIE criteria are not met.

In the example in ASC 810-10-55-8A through 55-8H, the FASB stated that other factors to consider when determining whether the equity holders have power include their ability to determine the decision maker’s compensation and to vote on the entity’s strategy and objectives. Reporting entities should carefully evaluate their VIE determinations when a corporation they are evaluating has outsourced decision making about significant activities. In these circumstances, a reporting entity will need to exercise judgment based on the facts and circumstances.

**Illustration 7-18: VIE determination: evaluation of the rights held by the equity holders**

Entity A, Entity B and Entity C are unrelated parties that form a corporation to distribute a product to an unrelated third party. The three investors decide to hire a manager, Entity D. Each equity investor receives one seat on the entity’s board of directors, and all board decisions require a simple-majority vote of the three board members. However, the investors only have protective rights with respect to approval of the annual operating budget (i.e., there is not a lot of detail set forth in the operating budget and the budget is not frequently reviewed by the Board such that the operations manager is not constrained by the Board’s rights with respect to the budget).

Assume that Entity D has a variable interest in the entity through the fees it receives as a manager. The board of directors can approve the compensation of Entity D, vote on the strategic direction of the entity and kick out Entity D without cause by exercising a simple majority vote. Assume the kick-out right is substantive.

**Analysis**

The corporation is not a VIE. Although Entity D carries out one of the activities of the entity that most significantly impacts the entity’s economic performance (i.e., operating decisions), the board of directors (on behalf of the shareholders) has power through its voting rights because of its substantive ability to remove and replace Entity D by exercising a simple majority vote and approve the compensation of Entity D.
7.3.1.3.2 Limited partnerships and similar entities

Based on the purpose and design of a limited partnership, the general partner usually has the ability to make decisions for the partnership through its general partner equity investment. However, as described in ASC 810-10-15-8A, kick-out rights through voting interests in a limited partnership are analogous to voting rights held by shareholders of a corporation. Therefore, when determining whether the at-risk equity holders have power over a limited partnership, the assessment will focus on whether the limited partners hold substantive kick-out rights or participating rights (see Section 7.3.1.3.3 and 7.3.1.3.4 for further guidance about evaluating whether kick-out rights or participating rights are substantive).

Assuming the other two characteristics of a VIE are not met, a limited partnership will not be a VIE and will be evaluated for consolidation under the voting model if either of the following conditions is met:

- A single limited partner, partners with a simple majority of voting interests or partners with a smaller voting interest with equity at risk are able to exercise substantive kick-out rights.
- Limited partners with equity at risk are able to exercise substantive participating rights.

If neither of these conditions exists, the partnership is a VIE.

When evaluating whether the threshold for kick-out rights has been met, a reporting entity will not consider voting interests held by the general partner, entities under common control with the general partner or other parties acting on behalf of the general partner.

### Illustration 7-19: VIE determination — no kick-out rights or participating rights

A general partner forms a limited partnership to develop commercial real estate and holds an at-risk equity interest of 6% in the partnership. The general partner also receives a management fee that is determined to be a variable interest. Two unrelated limited partners hold equal percentages (47% each) of the limited partnership interests, which are considered equity investments at risk. The general partner makes all of the significant decisions for the partnership. The limited partners do not hold substantive kick-out or participating rights.

#### Analysis

The partnership would be a VIE because (1) a single limited partner, partners with a simple majority of voting interests or partners with a smaller voting interest with equity at risk are not able to exercise substantive kick-out rights over the general partner and (2) limited partners with equity at risk are not able to exercise substantive participating rights over the general partner.
Illustration 7-20: VIE determination – simple majority of kick-out rights

A general partner forms a limited partnership to develop commercial real estate and receives a management fee. The fee arrangement includes terms that are not customarily present in arrangements for similar services. Therefore, the fee is determined to be a variable interest. The general partner holds no equity interest in the partnership. Two unrelated limited partners hold equal percentages (50% each) of the limited partnership interests, which are considered equity investments at risk. The general partner makes all of the significant decisions for the partnership, but limited partners with a simple majority of voting interests can remove the general partner without cause (assume there are no barriers to exercise the kick-out rights).

Analysis

The partnership would not be a VIE because partners with equity at risk are able to exercise a simple majority vote to remove the general partner without cause and there are no barriers that would prevent the partners with equity at risk from exercising those rights. This example assumes that none of the other VIE criteria are met.

When determining a limited partnership has sufficient equity at risk (i.e., applying ASC 810-10-15-14(a)), the equity at risk held by the general partner can be included. However, when determining whether equity holders lack the characteristics of a controlling financial interest (i.e., applying ASC 810-10-15-14(b)) the analysis is focused on whether the limited partners, and not the general partner, have power.

7.3.1.3.3 Kick-out rights

Under the Variable Interest Model, kick-out rights represent the ability to remove or “kick-out” the reporting entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance or to liquidate the VIE without cause (see Section 2.8 for the definition of kick-out rights). Kick-out rights must be substantive to be considered in the VIE analysis.

The barriers to exercise described below may indicate that the kick-out rights are not substantive. The FASB described these barriers in the context of limited partnerships and similar entities. However, we believe they are applicable to other types of entities as well (e.g., corporations).

Excerpt from Accounting Standards Codification

Consolidation – Overall

Recognition

810-10-25-14A

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.

810-10-25-14B

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.

810-10-25-14C

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.

We do not believe that an evaluation of these criteria should be determinative. Instead, we believe a reporting entity should carefully evaluate the facts and circumstances of each arrangement. The SEC staff also has expressed this view.

The economic terms of the kick-out rights could make it unlikely that they would be exercised. For example, assume a partnership that is a VIE has a provision in its partnership agreement that the general partner can be removed by one limited partner, but the general partner is still entitled to its economic interests over the remaining life of the partnership. Its economic interests include a 1% legal ownership interest and a 20% carried interest, which is earned after the limited partners receive a preferred return. We believe that the kick-out rights would not be substantive in this example because it is unlikely that the limited partner would remove the general partner when it must continue to pay that general partner for services for which the replacement general partner also will be compensated.

Some partnership agreements may provide that the general partner is to be paid an amount equal to the fair value of its interest on the termination date. The facts and circumstances should be evaluated to determine whether such a provision acts as a financial barrier. For example, a partnership that is invested in one real estate property may have insufficient liquidity to pay the general partner without selling the property, creating a significant disincentive for the limited partners to exercise the kick-out rights.

Agreements may provide for the removal of a decision maker or service provider only when a performance condition or other threshold has not been met. The performance condition's terms should be analyzed in these circumstances to determine whether it represents “cause.” We believe that the determination of whether a performance requirement represents “cause” should be made when the decision maker or service provider becomes involved with the entity and generally should not be assessed on an ongoing basis unless there has been a substantive change in the purpose and design of the entity.
In addition, the equity holders that have the kick-out rights must have the information necessary to exercise them for the kick-out rights to be substantive. When there are multiple equity holders, there must be a mechanism for an equity holder (or reasonable number of equity holders) to call for a vote to remove the decision maker or service provider. For example, if there were no mechanism to determine the identity of the other equity holders in the entity, it would be unlikely for an equity holder to exercise the kick-out rights. The terms of the entity’s governance documents or applicable laws and regulations should be evaluated carefully in determining whether the equity holders have the ability to obtain the information necessary to exercise the kick-out rights.

Barriers to exercise may be different when considering kick-out rights as compared to barriers to exercise liquidation rights. Therefore, careful consideration of the relevant factors is necessary when evaluating whether the liquidation rights are substantive.

Refer to ASC 810-10-55-4N through ASC 810-10-55-4W for examples of how to assess kick-out rights.

**Question 7.11** Should withdrawal (or redemption) rights be considered the same as kick-out rights under the Variable Interest Model?

As discussed in ASC 810-10-25-14B and paragraphs BC53 and BC54 in the Basis for Conclusions to ASU 2015-02, in certain limited circumstances, withdrawal (or redemption) rights may be considered substantive kick-out rights. For example, if a limited partnership is economically compelled to dissolve or liquidate upon the withdrawal of one limited partner, that withdrawal right may be considered a substantive kick-out right if there are no barriers to exercise and the right is otherwise considered substantive. However, withdrawal rights that do not require the dissolution or liquidation of the entire limited partnership generally are not considered substantive kick-out rights. Withdrawal rights must be analyzed carefully based on the facts and circumstances.

**Question 7.12** In an entity established by two equity investors, should a call option held by one investor to acquire the other investor’s equity interest be considered the same as a kick-out right under the Variable Interest Model?

Generally, no. The Variable Interest Model does not specifically address call options. However, we do not believe that a call option to acquire another party’s equity interest generally should be viewed as a kick-out right under the Variable Interest Model. An option generally provides the holder with an economic benefit but not current power (see Section 8.2.4.4).

### Participating rights

Under the Variable Interest Model, participating rights represent the ability to participate in or block the actions through which a reporting entity exercises its power to direct the activities of a VIE that most significantly impact the VIE’s economic performance (see Section 2.9 for the definition of participating rights). Determining what rights constitute participating rights likely will vary by entity because the activities that most significantly impact the economic performance differ by entity. The likelihood that the holder of a participating right will exercise that right should not be considered when assessing whether a participating right is substantive.

When a single party other than at-risk equity holders has the right to make or participate in decisions, emphasis should be placed on the ability of the participating party to block the actions of at-risk equity holders. However, ASC 810-10-15-14(b)(1) may not be violated if the participating rights are held collectively by multiple, unrelated parties that are not at-risk equity holders.
A holder of an interest that is not an equity investment at risk may hold protective rights (such as a lender through debt covenants) without violating ASC 810-10-15-14(b)(1). However, careful evaluation is required to distinguish a participating right from a protective right.

**Illustration 7-21: Participating rights held by holders of interests that are not equity investments at risk**

Assume that three unrelated entities (Entities A, B and C) form a corporation. Entity A has a 60% equity ownership in the entity, and Entities B and C each hold a 20% equity ownership. Entities B and C can both put their equity interests to Entity A at the end of five years for an amount equal to their original equity investment. Entity A can unilaterally make the significant decisions. However, Entity B has the ability to block Entity A's approval of the budget, a significant decision.

**Analysis**

Entities B and C are not holders of an equity investment at risk because their ability to put their interests to Entity A at the end of five years protects them from having to significantly participate in the losses of the entity. Entity A (the only at-risk equity holder) cannot make all of the significant decisions about the entity’s activities because Entity B has participating rights over one of the significant decisions (i.e., approval of the budget). Because Entity B (holder of an equity investment that is not at risk) has participating rights, the at-risk equity holders, as a group (i.e., Entity A), lacks the characteristics of a controlling financial interest and the entity is a VIE.

**7.3.1.3.5 Protective rights**

**Excerpt from Accounting Standards Codification**

**Consolidation – Overall**

**Implementation guidance and illustrations**

**810-10-55**

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 business 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.
Under the Variable Interest Model, protective rights are designed only to protect the interests of the party holding those rights (see Section 2.10 for the definition of protective rights). These rights do not provide the holder of such rights with power.

Significant judgment is required to distinguish a protective right from a participating right. While both could take the form of an approval or veto right, a distinguishing factor is the underlying activity or action to which the right relates. As the definition states, protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. Participating rights, on the other hand, relate to the activities that most significantly impact an entity's economic performance. Depending on the facts and circumstances, rights that are protective in the case of one reporting entity may not be protective in the case of another reporting entity.

The Variable Interest Model’s notion of protective rights is similar to that of voting interest entities. However, the list of protective rights in ASC 810-10-25-10 should not be viewed as all-inclusive, and determining whether a right is participating or protective is a matter of professional judgment. See Section C.3.2.2 for details of protective rights under the Voting Model.

7.3.1.4 Effect of decision makers or service providers when evaluating ASC 810-10-15-14(b)(1)

The question may arise as to whether an entity is a VIE when a decision maker or service provider has the power to direct the activities that most significantly impact the economic performance of the entity through a fee arrangement (rather than through an equity investment at risk), but its fee arrangement does not represent a variable interest.

The Variable Interest Model establishes criteria for determining whether fees received by an entity's decision makers or service providers represent variable interests in that entity. A decision maker or service provider must meet three criteria to conclude that its fees do not represent a variable interest (see Section 5.4.13). This analysis focuses on whether the decision maker or service provider is acting in a fiduciary capacity (i.e., as an agent of the equity holders) or as a principal to the transaction.

ASC 810-10-15-14(b)(1)(i)(O1) indicates that if an interest other than an equity investment at risk provides the holder of that interest with decision-making ability, but the interest does not represent a variable interest (e.g., the decision maker's or service provider's fee is not a variable interest based on the guidance in ASC 810-10-55-37), the criterion in ASC 810-10-15-14(b)(1) is not violated. The FASB reasoned that such a decision maker or service provider would never be the primary beneficiary of a VIE because it does not hold a variable interest. Additionally, such an interest typically would indicate that the decision maker or service provider was acting as a fiduciary, and the FASB observed that this fact alone should not lead to a conclusion that the entity is a VIE.

The FASB observed that this guidance is intended to prevent many traditional voting interest entities and certain investment funds from becoming VIEs. For example, if a property manager that is considered to have power over the entity concludes that it does not have a variable interest in the entity after evaluating ASC 810-10-55-37 through 55-38, the property manager's decision-making does not make the entity a VIE, because the property manager is acting as an agent on behalf of the equity holders.

Determining whether an entity is a VIE because it has a decision maker or service provider with power or participating rights through an interest separate from an equity investment at risk should be based on the facts and circumstances.

Often when a decision maker or service provider has a variable interest, the entity will be a VIE because the decision maker or service provider receives power or participating rights through its fee arrangements (rather than through an equity investment at risk). In making this determination, the nature of the rights held by the holders of the equity investment at risk (i.e., kick-out rights or participating rights) should be considered when at-risk equity holders with a simple majority or smaller voting rights have the ability to exercise those rights.
Illustration 7-22: Determining whether kick-out rights are substantive

Example 1
Assume that $80 of marketable debt securities and $20 of passive equity investments are transferred to a special purpose vehicle (SPV). The SPV funds the acquisition of the financial assets by issuing $40 of senior certificates to Company A, $40 of subordinate certificates to Company B, a $10 residual equity interest to Company C and a $10 residual equity interest to the transferor. The residual equity interests purchased by Company C and retained by the transferor are pari passu and are subordinate to the certificates issued to Company A and Company B. SPV has hired an unrelated investment manager (Asset Management Inc.) to manage its activities. Under the arrangement, Asset Management Inc. is paid a fee that is not commensurate with the level of effort required to provide the services. Therefore, the fee is considered a variable interest. The agreements specify that any one of the holders of the residual equity interests has the ability to remove Asset Management Inc., for cause.

Analysis
Asset Management, Inc. has the power and is not the holder of an equity investment at risk. In addition, the holders of the equity investment at risk do not have substantive kick-out rights giving them the ability to remove the asset manager. Therefore, the entity would be a VIE.

Example 2
Assume the same facts as in Example 1, except that Asset Management Inc. can be removed at any time without cause upon majority approval by the holders of the residual equity interests.

Analysis
Partners with a simple majority of voting interests are able to exercise substantive kick-out rights over Asset Management Inc. Therefore, the equity holders, as a group, have the power to direct the activities of an entity that most significantly impact the entity’s economic performance and the entity would not be a VIE (assuming none of the other VIE criteria are met).

7.3.1.5 Franchise arrangements when evaluating ASC 810-10-15-14(b)(1)
Franchise agreements generally stipulate specific business practices that the franchisee must follow. Therefore, a question arises as to whether franchise agreements result in a violation of ASC 810-10-15-14(b)(1).

A typical franchise agreement has as its purpose the distribution of a product, service or establishment of an entire business concept within a particular market area. Both the franchisor and the investors in the franchise contribute resources for establishing and maintaining the franchise. The franchisor's contribution may be a trademark, a company reputation, products, procedures, manpower, equipment or a process. The franchisee's investors usually contribute operating capital as well as the managerial and other resources required to open and operate the franchise.

The franchise agreement generally describes the specific marketing practices to be followed, specifies the contribution of each party to the operation of the business, and sets forth certain operating procedures that both parties agree to comply with. The franchise agreement may establish certain protocols relating to the management or operating policies of the franchise by, among other items: (1) specifying goods and services produced and sold by the franchise, (2) providing training of the franchise's employees, (3) establishing standards for the appearance of the franchise's place of business and (4) requiring that the franchise purchase raw materials or goods directly from the franchisor.
Although many of these decisions are important to the success of the franchise, the fact that certain of these decisions may be stipulated by the franchisor does not necessarily result in the entity being a VIE. By entering into a franchise agreement, at-risk equity investors in a franchise have decided to operate the business in a specific location under a common trademark and system and comply with the franchisor's business standards. A key consideration is whether the decisions stipulated through the franchise agreement are meant to protect the franchisor's brand or allow the franchisor to participate in ongoing substantive decision making relating to the franchise's operations. The ability of the franchisor to enforce business standards that protect the value of its brand, and the value of other investors' franchise entities, does not result in an entity being a VIE.

To be considered a voting interest entity, the at-risk equity investor(s) in the franchisee, as a group, should have the power to direct the activities of the franchise that most significantly impact the franchise's economic performance through voting or similar rights. The decisions must be substantive (i.e., decisions that may significantly affect the entity's revenues, expenses, margins, gains and losses, cash flows, financial position) and not ministerial in nature. In addition, the equity investors must have the ability to make whatever decisions are not pre-determined through the franchise agreement. These typically would include control over the operations of the franchise, including, but not limited to, hiring, firing and supervising of management and employees, establishing what prices to charge for products or services and making capital decisions of the franchise.

In some situations a franchisor may invest directly in the franchise through an equity position, loan or other means of subordinated financial support. In other situations, a franchisor may enter into arrangements that limit the investors' in the franchise obligation to absorb expected losses or receive expected residual returns of the franchise. In these situations, holding the power to direct the activities that most significantly impact the economic performance of the franchise becomes increasingly important to the franchisor because of its additional economic involvement.

The extent to which the franchisee's at-risk equity investors absorb expected losses and receive expected residual returns of the entity should be considered in determining whether, as a group, such holders lack the ability to make decisions about its activities. The greater the amount of their at-risk equity investment compared with the expected losses of the entity, the less likely it is that the investors would be willing to give up the ability to make decisions consistent with their interests or permit others to make decisions counter to their interests.

Although the amount of equity investment compared with expected losses may mitigate the franchisor's risk, in some instances the franchisor will require the franchisee to provide it with the power to direct the activities of the franchise that most significantly impact the franchise's economic performance. In those instances, the equity group would lack the characteristic in ASC 810-10-15-14(b)(1), and, as a result, the franchise would be considered a VIE. In other situations, the franchisor may require the franchisee to relinquish some, but not all, of its power to direct the activities of the franchise that most significantly impact the franchise's economic performance. Determining whether, as a group, the holders of a franchise's equity investment at risk have the ability to make substantive decisions about the entity's activities will be based on the facts and circumstances and will require the use of professional judgment.

FAS 167 nullified FSP FIN 46(R)-3, which included interpretative guidance on applying ASC 810-10-15-14(b)(1) to franchise arrangements. Under FSP FIN 46(R)-3, the rights of a franchisor in a franchise arrangement generally were considered protective rights. By including the rights of a franchisor as an example of a protective right in FAS 167, the FASB believes that the same objectives are achieved. Therefore, the FASB did not expect or intend for the nullification of FSP FIN 46(R)-3 to result in a significant change in practice to franchisors' evaluations of the criteria in ASC 810-10-15-14(b)(1).
### Limited liability companies

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments – Equity Method and Joint Ventures</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Partnerships, Joint Ventures, and Limited Liability Companies</strong></td>
</tr>
<tr>
<td><strong>Subsequent Measurement</strong></td>
</tr>
<tr>
<td>323-30-35-3</td>
</tr>
<tr>
<td>An investment in a limited liability company that maintains a specific ownership account for each investor – similar to a partnership capital account structure – shall be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in a limited liability company shall be accounted for using the cost method or the equity method.</td>
</tr>
</tbody>
</table>

### Limited Liability Entities – Overall

<table>
<thead>
<tr>
<th>Overview and Background</th>
</tr>
</thead>
<tbody>
<tr>
<td>272-10-05-2</td>
</tr>
<tr>
<td>A limited liability company generally has the following characteristics:</td>
</tr>
<tr>
<td>a. It is an unincorporated association of two or more persons.</td>
</tr>
<tr>
<td>b. Its members have limited personal liability for the obligations or debts of the entity.</td>
</tr>
<tr>
<td>c. It is classified as a partnership for federal income tax purposes.</td>
</tr>
<tr>
<td>272-10-05-3</td>
</tr>
<tr>
<td>Limited liability companies have characteristics of both corporations and partnerships but are dissimilar from both in certain respects. The following discussion compares characteristics typical of many limited liability company structures with characteristics of corporations or partnerships; however, those characteristics may not be present in all limited liability company structures.</td>
</tr>
<tr>
<td>272-10-05-4</td>
</tr>
<tr>
<td>Like a corporation, the members (that is, owners) of a limited liability company generally are not personally liable for the liabilities of the limited liability company. However, like a partnership, the members of an limited liability company – rather than the entity itself – are taxed on their respective shares of the limited liability company’s earnings. Unlike a limited partnership, it is generally not necessary for one owner (for example, the general partner in a limited partnership) to be liable for the liabilities of the limited liability company. Also, unlike a limited partnership in which the general partner manages the partnership, or a corporation in which the board of directors and its committees control the operations, owners may participate in the management of a limited liability company. Members may participate in a limited liability company’s management but generally do not forfeit the protection from personal liability afforded by the limited liability company structure. In contrast, the general partner of a limited partnership has control but also has unlimited liability, whereas the limited partners have limited liability like the members of a limited liability company. Additionally, all partners in a general partnership have unlimited liability. Like a partnership, financial interests in most limited liability companies may be assigned only with the consent of all of the limited liability company members. Like a partnership, most limited liability companies are dissolved by death, bankruptcy, or withdrawal of a member.</td>
</tr>
<tr>
<td>810-10-05-3</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
Limited liability companies (LLCs) have some characteristics of both corporations and partnerships. Illustration 7-23 compares the characteristics of many LLC structures and corporations or partnerships. These characteristics may not be present in all LLC structures.

**Illustration 7-23: Similarities and differences between LLCs, corporations and partnerships**

<table>
<thead>
<tr>
<th>Characteristic of an LLC</th>
<th>Similar to corporations</th>
<th>Similar to partnerships</th>
<th>Unique to LLCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Members of an LLC (i.e., its owners), generally are not personally liable for the LLC's liabilities.</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Members of an LLC – rather than the entity itself – are taxed on their respective shares of the LLC’s earnings.</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>All members of an LLC may directly participate in the management of an LLC and, in doing so, generally do not forfeit the protection from personal liability afforded by the LLC structure.</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Financial interests in most LLCs may be assigned only with the consent of all of the LLC members.</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LLCs generally are dissolved by death, bankruptcy or withdrawal of a member.</td>
<td></td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

Judgment may be required to determine whether an entity should be evaluated as a corporation or as a partnership, depending on the facts and circumstances. For example, the determination of whether the managing member’s responsibilities are substantive (e.g., making decisions about the activities that most significantly affect the economic performance of the LLC) or administrative (e.g., relating to taxes, insurance) may be indicative. Similarly, the role of the board of directors (if one exists) may also be informative in making this determination.

### 7.3.2 Obligation to absorb an entity’s expected losses

The entity does not have enough equity to finance its activities without additional subordinated financial support.

The equity holders, as a group, lack the characteristics of a controlling financial interest.

The entity is structured with non-substantive voting rights (i.e., anti-abuse clause).

- For an entity not to be a VIE, the at-risk equity holders (as a group) must have all of the following characteristics:
  - The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance
  - **The obligation to absorb an entity’s expected losses**
  - The right to receive an entity’s expected residual returns

To be considered a voting interest entity, the equity owners, as a group, must have the obligation to absorb the expected losses of the entity through the equity investments they hold. The equity owners do not have that obligation if the equity owners are directly or indirectly protected from expected losses or are guaranteed a return by the entity itself or by other parties involved with the entity (810-10-15-14(b)(2)).

We believe this means that, by design, for an entity to be considered a voting interest entity, the holders of the equity investment at risk cannot be shielded from the risk of loss on any portion of their investment by the entity itself or by others that are involved with the entity. That is, the holders of the equity investment at risk must absorb losses in the entity first and be subject to a total loss on their investment.
before exposing the other variable interest holders to loss (i.e., the holders of the equity investment must absorb the first dollar risk of loss). Therefore, we believe that by design, sharing exposure with non-equity holders or with instruments other than equity investments at risk (e.g., put options, guarantees) is not permitted. Guarantees and other arrangements that protect lenders or other variable interest holders in the entity after the holders of the equity investment at risk have suffered a total loss of their investment do not violate this condition. Additionally, an equity holder is not required to absorb losses beyond its initial contribution for an entity to be a voting interest entity.

Illustration 7-24: Shielding equity holders from the risk of loss

Company C and Developer B form a partnership by contributing $80 and $20, respectively. Company C and Developer B have voting and economic interests of 80% and 20%, respectively. Further Developer B receives a development fee of $25 from the partnership. Expected losses of the entity are determined to be $50. In this case, the developer’s equity investment at risk ($20) should be reduced by the fee ($25) it received and thus Developer B does not have an equity investment at risk.

Analysis

While the resulting equity investment at risk held by Company C ($80) is greater than the entity’s expected losses ($50), we believe the entity likely will be a VIE. Although the entity has sufficient equity, the Variable Interest Model requires the holders of the equity investments at risk to absorb the expected losses of the entity. Those equity holders cannot be indirectly protected from absorbing the first dollar risk of loss in the entity. Company C, the sole at-risk equity holder, is protected from absorbing 20% of the expected losses because those losses are allocable to Developer B, a holder of an equity investment not at risk. Developer B is not a holder of an equity investment at risk because its capital account should be reduced by the development fee it received (see Section 7.2.2.3). As such, the entity is a VIE because the at-risk equity holder (Company C) shares exposure to losses with the holder of an equity investment not at risk (Developer B) before suffering a total loss on its investment.

Illustration 7-25: Shielding equity holders from the risk of loss – fixed-price put

A partnership issues $96 of debt and $4 of equity, and uses those proceeds to purchase a share of common stock. The equity is determined to be sufficient. To protect the holders of the equity investment at risk against a decline in the value of the stock, the partnership purchases a put option that gives it the ability to sell the stock to the counterparty for $100.

Analysis

The equity holders are not subject to risk of loss because all downside risk has been transferred to the issuer of the put option, and thus, the entity is a VIE. In other words, the equity holders will never lose their investment unless the counterparty fails to perform and there is insufficient collateral.

However, if the put option’s exercise price is set at $96, it would protect only the lenders. The equity holders, as a group, would absorb the first dollar risk of loss of the entity, and the put option would protect only the lenders after the holders of the equity investment at risk suffered a total loss of their investment.
Residual value guarantees also may cause an entity to be a VIE.

**Illustration 7-26: Shielding equity holders from the risk of loss — residual value guarantee**

An LLC issues $190 of debt and $10 of equity. The equity is determined to be sufficient. Using the proceeds from these issuances, it acquires an asset for $200 and leases it to a third party under a 10-year lease. The debt matures in 10 years and does not amortize prior to maturity (i.e., it has a bullet maturity at the end of 10 years). The lender has recourse only to the leased asset and does not have recourse to the general credit of the LLC. The lessee has guaranteed that the residual value of the asset will be at least $200 at the end of the lease term.

**Analysis**

The LLC is a VIE because the residual value guarantee provided by the lessee protects both the equity holders and the lender from risk of loss associated with potential decreases in the value of the leased asset.

However, if the lessee guaranteed that the residual value of the asset will be at least $190 at the end of the lease term, the equity holders, as a group, would absorb the first dollar risk of loss of the entity, and the residual value guarantee would protect the lender only after the at-risk equity holders suffered a total loss of their investment. As a result, the entity would not be a VIE.

Certain arrangements including total return swaps, which pay the total return (i.e., interest, dividends, fees and capital gains/losses) in exchange for floating rate interest payments, by design, may cause an entity to be a VIE.

**Illustration 7-27: Shielding equity holders from the risk of loss — total return swap**

An entity issues $90 of debt and $10 of equity. The equity is determined to be sufficient. The entity uses the proceeds to purchase a fixed income instrument with a fair value of $100. Assume that the entity enters into a 90% total return swap with Investment Bank A. Under the swap agreement, the entity will pay 90% of the total return of that fixed income instrument in exchange for a LIBOR-based return.

**Analysis**

The holders of the equity investment at risk are protected from 90% of the asset’s losses. That is, as the fixed income instrument’s value declines by $1, the Investment Bank pays the entity 90 cents and, in effect, shields the holders of the equity investment at risk from 90 cents of the asset’s losses. Consequently, the equity investment, by design, is not exposed to risk of loss, making the entity a VIE.

**Question 7.13** Is an entity a VIE if equity holders are protected from risk of loss by instruments other than equity instruments, which are held or issued by other equity holders?

Yes. The obligation of variable interests other than equity interests to absorb expected losses of an entity may not be considered in determining whether the entity's at-risk equity holders have the obligation to absorb the entity's expected losses, even if the other variable interests are held or issued by an equity investor.
Illustration 7-28: An equity holder absorbs expected losses through an interest other than its equity investment

A partnership is formed by three investors: A, B and C. Each partner invests $1 million into the partnership and receives an equal partnership interest (all considered at risk). The partnership uses the funds to acquire an office building for $1.8 million. Investor A agrees to guarantee that the value of the building will be at least $1.8 million if it is sold during the 10 years following its purchase by the partnership, in exchange for a payment of $200,000. The partnership agreement requires that the partnership liquidate no later than the 10th anniversary of its formation.

Analysis

An equity holder is obligated to absorb any expected losses of the partnership upon the disposal of the building for less than $1.8 million because of the guarantee. However, because the obligation to absorb expected losses is embodied in an instrument other than an at-risk equity instrument, the partnership is a VIE.

7.3.2.1 Common arrangements that may protect equity investments at risk from absorbing losses

The following arrangements generally would protect equity investments at risk from absorbing losses and may result in the entity being a VIE:

- A variable interest holder reimburses the entity or the holders of the entity’s equity investment at risk for losses or has made arrangements for another party to do so (e.g., a guarantee of certain of an entity’s receivables that, by design, protects the equity holders).

- The allocation of the entity’s cash flows effectively removes the risk of loss from the holders of the entity’s equity investment at risk.

- A variable interest holder provides credit enhancements for assets of the entity, guarantees its debt or has arranged for another party to do so. (Guarantees and other arrangements that protect lenders to the entity after the holders of the equity investment at risk have suffered a total loss of their investment do not prevent the equity holders from absorbing losses but may raise a question about the sufficiency of the equity).

- A variable interest holder guarantees residual values of assets comprising more than half of the fair value of the entity’s total assets or agrees to future purchases of such assets at predetermined prices that protect the equity holders from risk of loss or has made arrangements for another party to do so.

- Contractual arrangements for a purchaser to acquire the majority of an entity’s goods or services at a price based on the actual costs incurred to produce the good or service plus a specified margin (i.e., a cost-plus arrangement). For example, if the cost to acquire the goods or services exceeds their fair values, the acquirer may be providing a form of subordinated financial support, which may result in the entity being a VIE. The terms of the cost-plus arrangement should be evaluated carefully to determine whether it protects holders of the equity investment from absorbing losses.
**Question 7.14**

Entities commonly enter into normal and customary business arrangements to protect equity holders from the risk of loss (e.g., property and casualty insurance, hedging arrangements). Do these arrangements result in an entity being a VIE?

ASC 810-10-15-14(b)(2) is meant to identify structures that, by design, protect the equity investors from losses arising from the primary economic risks of the entity. That is, the criterion is designed to identify structures in which the equity interests lack economic substance. While certain normal and customary business arrangements, such as obtaining property and casualty insurance and business interruption insurance, protect the equity holders from risk of loss, we do not believe they result in the entity, by design, being a VIE. An entity’s terms should be evaluated carefully to determine whether an arrangement that protects equity holders from risk of loss is normal and customary. Any derivative contract that transfers all or substantially all of the entity’s variability to the counterparty (e.g., certain total return swaps) generally is not a normal and customary hedging arrangement.

### Illustration 7-29: Normal and customary business arrangements

A large publicly traded company (i.e., the Company) owns and operates 10 crude oil refineries in the US and has been operating in the crude oil refining and marketing business since it went public in 1956. To manage certain of its business risks, the Company purchases business interruption insurance, and property and casualty insurance, and locks in the difference between the cost of crude and the sales price of refined products on 60% of its future expected processing runs using total return swaps and other derivatives.

**Analysis**

The Company is not a VIE simply because of the risk management programs. The criterion in ASC 810-10-15-14(b)(2) is meant to identify entities that, by design, protect the holders of the entity’s equity investment at risk from losses arising from the primary economic risks of the entity. While certain normal and customary business practices, such as the acquisition of insurance or hedging activities, protect the equity holders from risk of loss, they do not result in the entity’s being a VIE.

Judgment is required to determine whether, by design, the holders of the equity investment at risk are protected from first dollar risk of loss.

### Illustration 7-30: Indemnity in a business acquisition transaction

Company A owns Entity X, which produces and sells semiconductors. Company B acquires 100% of Entity X from Company A, in a business combination. As part of the transaction, Company A provides an indemnification to Company B for uncertainties about the settlement amounts of certain liabilities assumed by Company B. The indemnity relates to losses that may arise from discrete events that occurred prior to the transaction (e.g., workers compensation or product liability claims). Company A makes general representations and warranties that these losses are not expected to be significant.

**Analysis**

Indemnities of this nature are normal and customary business practices. In this example, we do not believe Entity X is a VIE simply because of this indemnity. The indemnity does not protect the equity holders from the economic risks Entity X was designed to create and pass through to its variable interest holders (i.e., Company B). Rather, the indemnity relates to discrete events that occurred prior to the transaction and that are clearly separable from Entity X’s ongoing operations.
7.3.2.2 Disproportionate sharing of losses

Because the holders of the equity investment at risk, as a group, must absorb the entity’s expected losses, we believe the holders of the equity interests may agree to share losses in a manner that is disproportionate to their respective ownership interests in the entity without the entity being a VIE. For example, we believe that allocation formulas that distribute losses among equity holders through rights and obligations embodied in their equity interests generally are consistent with this requirement.

Illustration 7-31: Disproportionate sharing of losses

A general partner manages the activities of a limited partnership while the limited partners contribute capital and share in the profits but take no part in running the business. The general partner is liable for partnership debts while the limited partners incur no liability with respect to partnership obligations beyond their capital contributions.

Analysis

While the limited partners participate in the expected losses of the entity disproportionately with the general partner, the criterion in ASC 810-10-15-14(b)(2) is applied to the equity holders as a group. The criterion therefore is not violated.

Although this criterion is to be applied to the holders of the entity’s at-risk equity investment, as a group, profit-sharing arrangements should be evaluated carefully to ensure that each investor’s equity interest participates significantly in losses of the entity as described in Section 7.2.2.1. Additionally, when the allocation of profits and losses to the equity holders are disproportionate to their voting interests, the Variable Interest Model’s anti-abuse provisions should be evaluated carefully (see Section 7.4).

7.3.2.3 Variable interests in specified assets or silos

As described in Section 5.5, a reporting entity may hold a variable interest that is related to a specific asset or group of assets of an entity (as opposed to a variable interest in all of the assets of the entity, which is characteristic of an equity holder). This determination is important because if a party has only a variable interest in specified assets of a VIE but does not have a variable interest in the VIE as a whole, it cannot be required to consolidate the VIE. If a reporting entity has a variable interest in the VIE as a whole, it is required to evaluate whether it is the primary beneficiary of the VIE.

The Variable Interest Model has special provisions to determine whether a reporting entity with a variable interest in specified assets of an entity has a variable interest in the entity as a whole. A variable interest in specified assets of an entity is a variable interest in the entity as a whole only if (1) the fair value of the specified assets is more than half of the fair value of the entity’s total assets, or (2) the variable interest holder has another variable interest in the entity as a whole (except interests that are insignificant or have little or no variability).

If a variable interest is not a variable interest in the entity as a whole, that variable interest should not be considered in evaluating whether the entity’s at-risk equity holders have the obligation to absorb expected losses. As a result, guarantees on a portion of an entity’s assets may not automatically result in an entity being a VIE.

Similarly, variable interests in silos of a host entity are not variable interests in the host entity, itself, and should not be considered in evaluating whether the entity’s at-risk equity holders have the obligation to absorb expected losses (see Chapter 6 for guidance on identifying silos).
Illustration 7-32: Interests in specified assets

An LLC is formed to acquire and operate two office buildings and to sell the buildings at the end of five years. The LLC issues debt of $90 million and equity of $10 million and acquires Building One and Building Two for $60 million and $40 million, respectively. The buildings are leased to separate third-party tenants. The tenant of Building Two guarantees that the value of the building will be at least $40 million at the end of five years.

Analysis

The fair value of Building Two is less than half of the fair value of LLC’s total assets. Therefore, the guarantee provided by the tenant represents a variable interest in a specified asset (i.e., Building Two) and not the entity as a whole. As such, expected losses of Building Two that are absorbed by the tenant are not considered in evaluating whether the equity holders, as a group, have the obligation to absorb losses in the LLC. That is, ASC 810-10-15-14(b)(2) is not violated.

However, if the guarantee is for $60 million on Building One instead of Building Two, the guarantee would be a variable interest in the entity as a whole because Building One comprises more than one-half of the fair value of the entity’s total assets. The tenant of Building One would have a variable interest in the entity as a whole. As such, expected losses of Building One that are absorbed by the tenant are considered in evaluating whether the equity holders, as a group, have the obligation to absorb losses in the LLC. Because that variable interest would protect the equity holders from risk of loss, ASC 810-10-15-14(b)(2) is violated and the entity would be a VIE. We believe the variability created by each building, as well as the overall design and purpose of the structure, should be evaluated in determining whether the entity is a VIE.

7.3.2.4 Illustrative examples

These examples illustrate whether, as a group, the holders of the equity investment at risk are protected directly or indirectly from expected losses or are guaranteed a return by the entity itself or by other parties involved with the entity.

Illustration 7-33: Obligation to absorb expected losses

Example 1

Lessor XYZ operates a building to be leased by Company ABC. The building is financed with 80% debt ($400 million), with all of the principal due at maturity, and 20% equity ($100 million). The lease term is 10 years. The equity holders are not constrained from selling their interest in Lessor XYZ, make all decisions about the operations of the building and may at any time expand the building and lease space to other lessees. Lessor XYZ has the right to put the building to Company ABC at the end of 10 years for 90% of the building’s fair value at inception or $450 million.

Analysis

The put option limits the losses that will be absorbed by the equity holders to $50 million resulting from decreases in the fair value of the building below $450 million. Because the holders of the entity’s equity investment at risk are protected from risk of loss of their investment through the existence of the put option, the entity is a VIE.

Example 2

Assume the same facts as in Example 1, except that the put option does not exist. Instead, Company ABC guarantees that at the end of 10 years, the building will be worth at least 10% of its fair value at inception, or $50 million.
Analysis
The guarantee does not protect the equity investors from risk of loss but rather prevents the lenders from losing more than $350 million if Lessor XYZ defaults on the loan and the building is worth less than $50 million upon foreclosure. If Company ABC is called upon to perform under the guarantee, the value of the building will have decreased by at least $450 million, and the equity investors will have suffered a complete loss of their investment. Accordingly, the provisions of ASC 810-10-15-14(b)(2) are not violated, and the entity is not a VIE (assuming the other VIE criteria are not met).

Example 3
Assume the same facts as in Example 2, except that instead of guaranteeing the value of the building, Company ABC writes an option giving the debt holders the ability to put the building to it for $250 million at the end of 10 years if the debt holders foreclose on the building.

Analysis
The put option provided by Company ABC provides protection only to the lenders. The fixed price put option provided to the debt holders would be effective only when the equity investment at risk has been eliminated. Because the holder of the entity’s equity investment at risk absorbs 100% of the first dollar of expected losses, the provisions of ASC 810-10-15-14(b)(2) are not violated, and the entity is not a VIE (assuming the other VIE criteria are not met).

7.3.3 Right to receive an entity’s expected residual returns
The Variable Interest Model requires the equity holders, as a group, to have the right to receive the entity’s expected residual returns (810-10-15-14(b)(3)). The equity owners do not have that right if their return is capped by the entity’s governing documents, by instruments other than equity investments at risk (even if those rights are held by equity holders) or through arrangements with the entity.

We believe the term “cap” means that the holders of the equity investment at risk have no right to receive or participate in the entity’s expected residual returns above a certain point. We believe there is a distinction between capping and reducing or diluting the entity’s expected residual returns. Provisions that limit the returns to the entity’s at-risk equity holders should be evaluated to determine whether they are, in essence, a cap.

For example, we believe that an entity that writes a call option on an asset that, by design, explicitly caps the return of the equity holders is a VIE. We believe one result of this provision is that a lessor entity that, by design, has a single asset that is leased under an operating lease with a fixed price purchase option will be a VIE. For example, assume an entity has a building ($100) that was financed with debt ($90) and equity ($10). The building is leased to Company Y in an operating lease. At the lease termination date, Company Y
has an option to buy the building for a fixed price of $100. In this case, if the building were to have a value higher than $100 at the lease termination, the lessee would exercise the option and directly cap the equity investors’ return. Because the equity investors’ rights to receive the expected residual returns are capped, we believe the entity is a VIE. Judgment will be required in determining whether, by design, a call option caps the returns of the holders of the equity investment at risk.

ASC 810-10-15-14(b)(3) indicates that convertible stock or stock options do not cap the returns of the equity holders because, upon conversion, the instrument holders would be equity holders. We believe that the instruments cited in ASC 810-10-15-14(b)(3) dilute, rather than cap, the expected residual returns of the group of the at-risk equity investors. As such, we do not believe that those instruments would result in an entity being a VIE. However, we believe the terms of call options on the entity’s stock or its assets should be evaluated carefully because they may, by design, cap the at-risk equity investors’ returns.

We believe a determination also should be made about whether the call options are part of the entity’s design. We do not believe the Variable Interest Model requires each of an entity’s variable interest holders to perform an exhaustive analysis to determine all of the other holders’ rights and obligations. Instead, we believe an interest holder should assess whether the call option is a key element of the overall structure and design of the entity of which the holders are aware or should be through the transaction documents themselves and inquiry.

Illustration 7-34  Call option to acquire 100% of entity’s assets

An entity owns Asset 1 and Asset 2, which have fair values of $51 and $49, respectively. The entity has equity of $100, contributed by a limited number of stockholders. The entity has written a call option to an unrelated party to acquire both assets for $110 at a future date.

Analysis

We believe the entity is a VIE because the expected residual returns to the holders of the equity investment at risk are capped through the call option on all of the entity’s assets. That is, the call option (i.e., an instrument other than the equity investment at risk) prevents the holders of the equity investment, as a group, from having the characteristics of a controlling financial interest.

Illustration 7-35:  Call option to acquire 100% of entity’s outstanding stock

Assume the same facts as Illustration 7-34, but the stockholders, by design, have written a call option to an unrelated party to acquire 100% of the entity’s outstanding voting stock for $110 at a future date.

Analysis

We believe the entity is a VIE. The substance of Illustrations 7-34 and 7-35 is identical. In each case, the returns of the current group of at-risk equity holders are capped. For the entity to be a voting interest entity, no interests can prevent the equity holders from having the necessary characteristics described in ASC 810-10-15-14(b). The call option is a separate instrument that caps the returns of the current group of equity holders. Thus, the entity is a VIE.
### Illustration 7-36: Call option to acquire a percentage of entity's assets

Assume the same facts as Illustration 7-34, but the entity has written a call option to an unrelated party to acquire Asset 1 (51% of the entity’s assets) for $55 at a future date.

**Analysis**

We believe the determination of whether the entity is a VIE depends on the facts and circumstances. Although the entity has written an option to buy a majority of the entity’s assets at a fixed price, the stockholders’ returns are not capped as they continue to have a right to the entity’s residual rewards on its remaining assets (49% of the total). By design, the equity holders’ returns are not capped. Rather, the equity holders have diluted their interest in the entity’s returns and limited their upside but have not capped their returns. Indeed, they participate fully in the returns on 49% of the assets, which could be significantly more volatile than the majority of its assets.

We believe the variability of the respective assets should be evaluated and compared (with consideration of the purpose and design of the entity) to determine whether the call option on the majority of the entity’s assets results in the entity’s classification as a VIE under ASC 810-10-15-14(b). See Section 7.3.3.2 on variable interests in specified assets.

---

### Question 7.15

Does ASC 810-10-15-14(b)(3) require the holders of an entity’s equity investment at risk to receive all of the entity’s expected residual returns? May other variable interest holders share in the expected residual returns of an entity and the entity still not be a VIE?

The equity holders may share a portion of the residual returns of an entity with other variable interest holders provided that the sharing arrangement does not explicitly or implicitly cap the returns that inure to the equity holders, as a group.

### Illustration 7-37: Participation of other variable interest holders in expected residual returns

Four companies form a partnership to invest in commercial real estate. Each company holds a 25% interest in the partnership, and each equity investment is deemed to be at risk. The partnership acquires a newly constructed office building and partially finances the acquisition with debt from a senior secured lender.

The partnership engages the developer of the office building to act as the property manager. In this role, the developer will make decisions about the selection of tenants, negotiation of lease terms, setting of rental rates, capital expenditures, and repairs and maintenance, among other things.

The developer will receive a fee of $250,000 per year for acting as the property manager. In addition, the partners agree that the developer will receive 50% of all returns of the partnership once an IRR of 15% has been achieved.

**Analysis**

In this example, the returns to the holders of the entity’s equity investment at risk are not capped because they will continue to receive one-half of all amounts exceeding a 15% IRR. Accordingly, the provisions of ASC 810-10-15-14(b)(3) are not violated.
7.3.3.1 Disproportionate sharing of profits

Because ASC 810-10-15-14(b)(3) is applied to the holders of the entity's equity investment at risk, as a group, the holders may agree to share profits through their equity interests in a manner that is disproportionate to their ownership interests in the entity without the entity's being a VIE. Allocation formulas that distribute profits among the equity holders through rights and obligations embodied in their equity interests are generally consistent with this requirement.

Illustration 7-38: Disproportionate sharing of profits

An entity is created by Strategic Co. (25% of equity) and Financial Co. (75% of equity). The operating agreement states that profits are to be allocated based on each party's relative ownership until Financial Co. achieves an internal rate of return of 15% on its investment. From that point on, profits are to be distributed to Strategic Co. and Financial Co. at a rate of 75% and 25%, respectively.

Analysis

We believe ASC 810-10-15-14(b)(3) would not be violated because the holders of the equity investment at risk, as a group, receive the expected residual returns of the entity.

Illustration 7-39: Disproportionate sharing of profits

Two oil and gas exploration companies, Oilco and Gasco, form a limited partnership and contribute certain unproven and proven oil- and gas-producing properties in exchange for equal partnership interests. The partners agree that, in exchange for acting as the general partner, Oilco will receive all profits until a cumulative 10% IRR is achieved. Gasco will then receive all profits until a cumulative 20% IRR is achieved. All profits in excess of a cumulative 20% IRR will then be allocated to Oilco.

Analysis

While this profit distribution caps Gasco's return, Oilco's return is not capped. Because the holders of the equity investment at risk, as a group, receive the expected residual returns of the entity, the provisions of ASC 810-10-15-14(b)(3) are not violated.

Although criterion 810-10-15-14(b)(3) (the right to receive an entity's expected residual returns) is to be applied to the holders of the entity's at-risk equity investment, as a group, profit sharing arrangements should be evaluated carefully to ensure that each investor's equity interest participates significantly in the profits of the entity as described in Section 7.2.2.1. Additionally, when the allocation of profits and losses to the equity holders are disproportionate to their voting interests, the Variable Interest Model's anti-abuse provisions should be evaluated carefully (see Section 7.4).

7.3.3.2 Variable interests in specified assets or silos

As described in Chapter 5, the Variable Interest Model has special provisions to determine whether a reporting entity with a variable interest in specified assets of an entity has a variable interest in the entity as a whole. A variable interest in specified assets of an entity is a variable interest in the entity as a whole only if (1) the fair value of the specified assets is more than half of the fair value of the entity's total assets, or (2) the variable interest holder has another variable interest in the entity as a whole (except interests that are insignificant or have little or no variability).

If a variable interest is not a variable interest in the entity as a whole, that variable interest should not be considered in evaluating whether the entity's at-risk equity holders have the right to receive the entity's expected residual returns. Even if a cap on the return of an asset is considered to be a variable interest in the entity as a whole, judgment should be applied based on the facts and circumstances to determine whether the cap, by design, caps the returns of the group of at-risk equity investors.
Similarly, variable interests in silos of a host entity are not variable interests in the host entity, itself, and should not be considered in evaluating whether the entity's at-risk equity holders have the right to receive the entity’s expected residual returns (see Chapter 6 for guidance on identifying silos).

**Illustration 7-40: Interests in specified assets**

An LLC is formed and issues debt of $90 million and equity of $10 million. The LLC acquires Building One for $60 million and Building Two for $40 million. Each building is leased to separate third-party tenants. The lease terms for Building Two allow the tenant to purchase the building for $40 million at the end of five years.

**Analysis**

The fair value of Building Two is less than half of the fair value of LLC’s total assets. Therefore, the fixed price purchase option represents a variable interest in a specified asset (i.e., Building Two) and not the entity as a whole. As such, the expected residual returns allocable to the fixed price purchase option should not be considered in evaluating whether the return to the equity holders as a group is capped. That is, ASC 810-10-15-14(b)(2) is not violated.

Conversely, if the lease terms for Building One allowed the tenant to purchase that building at the end of five years for $60 million, the purchase option would give the tenant a variable interest in the entity as a whole because Building One comprises more than one-half of the fair value of the entity's total assets. Because the purchase option would cap the returns inuring to the equity holders from Building One, further analysis would be required to determine whether, by design, the equity investors’ returns are capped. We believe the variability created by each building, as well as the overall design and purpose of the structure, should be evaluated in determining whether the entity is a VIE.

### 7.3.3.3 Illustrative examples

These examples illustrate whether, as a group, the holders of the equity investment at risk, do not have the right to receive the expected residual returns of an entity.

**Illustration 7-41: Right to receive expected residual returns**

Lessor XYZ operates a building to be leased by Company ABC. The building was financed with 80% debt ($400 million) and 20% equity ($100 million). The lease term is 10 years. At the end of Year 10, the lessee has an option to buy the building for a fixed price of $500 million. The equity holder is not constrained from selling its interest in Lessor XYZ, makes all decisions about the operations of the building and may at any time expand the building and lease space to other lessees.

**Analysis**

The entity is a VIE because the fixed price purchase option caps the expected residual returns of the at-risk equity holders.

**Illustration 7-42: Right to receive expected residual returns**

A large publicly traded company (i.e., the Company) owns and operates 10 crude oil refineries in the US and has been operating in the crude oil refining and marketing business since it first went public in 1956. The Company also has a profit-sharing plan that provides its employees with up to 10% of its annual operating profit.

**Analysis**

The provisions of ASC 810-10-15-14(b)(3) are not violated simply because of the employee profit-sharing plan. Sharing of an entity’s profits with parties other than holders of the equity investment at risk is permitted as long as that sharing does not cap the at-risk equity holders’ returns.
Illustration 7-43: Right to receive expected residual returns

Assume $80 of marketable debt securities and $20 of passive equity investments are transferred to a special purpose vehicle (SPV). SPV funds the acquisition of the financial assets by issuing $40 of senior certificates to Company A, $40 of subordinate certificates to Company B, a $10 residual equity interest to Company C and a $10 residual equity interest to the transferor. Both the residual equity interests purchased by Company C and retained by the transferor are pari passu and subordinate to the certificates issued to Company A and Company B. SPV hires C Management Fund (CMF) to be the asset manager. The asset management agreement provides CMF with the ability to buy and sell securities for profit and stipulates that CMF will receive a fixed fee of $5,000 per month, plus any residual profits after the residual equity interest holders receive a 15% IRR.

Analysis

The return to the at-risk equity holders is capped at a 15% IRR. Because the return to the residual equity interest holders is capped, the SPV is a VIE.

7.4 Entity established with non-substantive voting rights

Excerpt from Accounting Standards Codification

Consolidation — Overall

Scope and Scope Exceptions — Variable Interest Entities

810-10-15-14

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.

The last criterion to consider when evaluating whether an entity is a VIE is whether the entity was established with non-substantive voting rights. This criterion is known as the anti-abuse test. The purpose of this test is to prevent a reporting entity from avoiding consolidation of an entity by organizing the entity with non-substantive voting interests.
Under this test, an entity is a VIE if (1) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their right to receive the expected residual returns or both and (2) substantially all of the entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights, including its related parties and certain de facto agents. We refer to each of these conditions as Condition 1 and Condition 2, which are described further below.

### Illustration 7-44: Anti-abuse test

Company A, a manufacturer, and Company B, a financier, establish an entity. The operating agreement states that the entity may purchase only Company A’s products. Company A’s and Company B’s economic interests in the entity are 70% and 30%, respectively. Company B has 51% of the outstanding voting rights.

**Analysis**

The entity is a VIE because substantially all of the entity’s activities (i.e., buying Company A’s products) are conducted on behalf of Company A, whose economic interest exceeds its voting rights.

A disproportionate interest does not automatically lead to a conclusion that an entity is a VIE. Substantially all of an entity’s activities must involve or be conducted on behalf of the investor that has disproportionately few voting rights for an entity to be a VIE. The Variable Interest Model does not provide guidance to determine what constitutes substantially all of an entity’s activities. We believe this determination will be based on the individual facts and circumstances and will require the use of professional judgment.

### 7.4.1 Condition 1: Disproportionate votes to economics

- The entity does not have enough equity to finance its activities without additional subordinated financial support.
- The equity holders, as a group, lack the characteristics of a controlling financial interest.
- The entity is structured with non-substantive voting rights (i.e., anti-abuse clause).

An entity is a VIE if both of the following conditions are met:

- The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their right to receive the expected residual returns or both, and
- Substantially all of the entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights, including that investor’s related parties and certain de facto agents.

We believe that any disproportionality between an investor’s voting rights and its obligation to absorb the entity’s expected losses or receive its expected residual returns meets Condition 1 of the anti-abuse test and requires the reporting entity to consider Condition 2.

An investor’s voting percentage may not be clear. As a result, the entity’s underlying documents should be reviewed. In a limited partnership, a general partner may have 100% of the vote, and each limited partner may have 0% of the vote. In other entities, both parties may have to agree before certain major actions are undertaken (e.g., approval of operating budgets or issuing, refinancing debt). In these situations, we generally believe each party has 50% of the vote when evaluating Condition 1 of ASC 810-10-15-14(c).

Many entities have an investor that has disproportionately fewer voting rights than its economic interest would suggest because of the entity’s profit- or loss-sharing formula, or because an investor has a variable interest other than its voting equity interest (e.g., subordinated debt, fee arrangement).
However, an entity is not a VIE solely because Condition 1 of ASC 810-10-15-14(c) has been met. For the entity to be a VIE, Condition 2 also must be met. That is, substantially all of the entity’s activities must either involve or be conducted on behalf of the investor with disproportionately few voting rights, including its related parties and certain de facto agents.

<table>
<thead>
<tr>
<th>Illustration 7-45: Determining whether voting rights are proportionate to economic rights</th>
</tr>
</thead>
</table>
| **Example 1**  
Partner A and Partner B contribute $66 and $34, respectively, in exchange for equity interests in a newly formed entity. Each party must approve major operating activities before those activities are undertaken. Profits and losses are allocated in proportion to each partner’s capital balance.  
**Analysis**  
Partner A has 50% of the entity’s voting rights but is entitled to 66% of its underlying economics. Therefore, Condition 2 of the anti-abuse clause must be evaluated to determine whether the entity is a VIE.  
**Example 2**  
Assume the same facts as Example 1, except that Partner B makes a loan to the entity, which increases its obligation to absorb the entity’s expected losses to 54%.  
**Analysis**  
Partner B has 50% of the entity’s voting rights but is obligated to absorb 54% of the entity’s expected losses. Therefore, Condition 2 of the anti-abuse clause must be evaluated to determine whether the entity is a VIE. |

<table>
<thead>
<tr>
<th>Question 7.16 In determining whether an investor has disproportionately fewer voting rights than its obligation to absorb expected losses or receive expected residual returns of the entity would suggest, should the comparison be based only on the rights and obligations of equity investments, or should all variable interests held by an investor be considered?</th>
</tr>
</thead>
</table>
| The FASB intended that the anti-abuse clause be applied broadly to all interests held in a potential VIE to determine whether an investor has disproportionately few voting rights compared with its obligations to absorb expected losses or rights to receive expected residual returns. Accordingly, all variable interests held by an investor should be considered in determining whether the investor has disproportionately few voting rights in the entity.  
| Illustration 7-46: Variable interests to be considered when applying the anti-abuse clause  
A reporting entity holds a 10% equity ownership interest in an entity and also has provided debt financing to the entity such that, in the aggregate, it has provided 70% of the entity’s total capitalization. The reporting entity’s voting rights in the entity are proportionate to its 10% equity ownership interest. Substantially all of the entity’s activities are conducted on behalf of the reporting entity.  
**Analysis**  
Because the reporting entity has an overall economic position in the entity equal to 70% of its capitalization (based on the aggregate of its combined debt and equity position), but has only a 10% voting interest, its obligation to absorb expected losses is disproportionate to its voting interest. Therefore, Condition 1 has been met. Also, substantially all of the entity’s activities are conducted on behalf of the reporting entity, which has disproportionately few voting rights. Therefore, the entity is a VIE. |
7.4.2 Condition 2: Substantially all of an entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights

We believe that any disproportionality between an investor's voting rights and its obligation to absorb the entity's expected losses or receive its expected residual returns requires a determination of whether Condition 2 of ASC 810-10-15-14(c) has been met.

Determining whether substantially all of the entity's activities either involve or are conducted on behalf of an investor, including the investor's related parties and certain de facto agents, will require judgment and will be based on a qualitative assessment of the applicable facts and circumstances. Although the amount of the entity's economics attributable to the investor with disproportionately few voting rights is a factor that should be considered, the anti-abuse test is not based solely on a quantitative analysis.

We believe the activities of the potential VIE should be compared with those of the variable interest holders in the entity. The nature of the entity's activities, the nature of each variable interest holder's activities exclusive of its investment in the entity, the rights and obligations of each variable interest holder and the role that each variable interest holder has in the entity's operations, among other factors, should be considered. If the activities of the entity involve or are conducted on behalf of the investor that holds disproportionately few voting rights, or on behalf of that investor's related parties or certain de facto agents, the entity is a VIE.

Factors that should be considered in determining whether the activities involve or are conducted on behalf of the investor\textsuperscript{20} with disproportionately few voting rights include:

\begin{itemize}
  \item Are the entity's operations substantially similar in nature to the activities of the investor with disproportionately few voting rights?
  \item Are the entity's operations more important to the investor with disproportionately few voting rights than the other variable interest holders?
  \item What decisions does the investor with disproportionately few voting rights participate in and to what extent?
  \item Are the majority of the entity's products or services bought from or sold to the investor with disproportionately few voting rights?
\end{itemize}

\textsuperscript{20} For purposes of evaluating the factors listed, the term “investor” should be read to include the investor and the investor's related parties and certain de facto agents under ASC 810-10-25-43.
Determining whether an entity is a VIE

Financial reporting developments
Consolidation and the Variable Interest Model | 173

• Were substantially all of the entity’s assets acquired from the investor with disproportionately few voting rights?

• Are employees of the investor with disproportionately few voting rights actively involved in managing the operations of the entity?

• What roles do the variable interest holders play in conducting the entity’s operations?

• Do employees of the entity receive compensation tied to the stock or operating results of the investor with disproportionately few voting rights?

• Is the investor with disproportionately few voting rights obligated to fund operating losses of the entity, or is the entity economically dependent on the investor?

• Has the investor with disproportionately few voting rights outsourced certain of its activities to the entity, or vice versa?

• If the entity conducts research and development activities, does the investor with disproportionately few voting rights have the right to purchase any products or intangible assets resulting from the entity’s activities?

• Has a significant portion of the entity’s assets been leased to or from the investor with disproportionately few voting rights?

• Does the investor with disproportionately few voting rights have a call option to purchase the interests of the other investors in the entity? Fixed price and “in the money” call options are stronger indicators than fair value call options.

• Do the other investors in the entity have an option to put their interests to the investor with disproportionately few voting rights? Fixed price and “in the money” put options are stronger indicators than fair value put options.

Not all of these conditions must be present to conclude that the activities of the entity are conducted principally on behalf of the investor with disproportionately few voting rights. Determining whether substantially all of a potential VIE’s activities involve or are conducted on behalf of an investor with disproportionately few voting rights, including that investor’s related parties and certain de facto agents, requires the use of professional judgment after considering all the facts and circumstances.

Question 7.17

A limited partnership may have a general partner that maintains a relatively minor partnership interest. If the limited partners have protective voting rights (as that term is defined in the Variable Interest Model) in the partnership and the general partner has all of the substantive decision making ability, will such an entity always be a VIE as a result of the Variable Interest Model’s anti-abuse clause?

We do not believe all limited partnerships will be VIEs due to the anti-abuse clause. Although the limited partners have disproportionately few voting rights, the anti-abuse clause is applicable only if substantially all of the entity's activities are conducted on behalf of the limited partner, including its related parties or certain de facto agents (see Section 7.4.2). The factors described above should be considered to determine whether the anti-abuse clause is applicable.
Illustration 7-47: Limited partnerships and the anti-abuse test

A limited partnership is formed to develop multi-family residential housing projects. A real estate development company identifies the site for the housing project, does pre-construction development work, syndicates the partnership interests and serves as the general partner. As general partner, the developer is responsible for constructing the housing project and maintaining and operating the project once constructed. The general partner holds a 1% interest in the partnership, and one limited partner holds the remaining 99% limited partnership interest. The limited partner is not actively involved in real estate development or the provision of residential housing and holds its interest for investment purposes.

Analysis

It could be argued that the entity is a VIE because the voting rights of the limited partner are not proportional to its obligations to absorb the expected losses of the entity or receive its expected residual returns (i.e., the limited partner has up to 99% of the partnership’s economics and no significant voting rights). In addition, if the magnitude of the economic interest is emphasized in the analysis, it would appear that substantially all of the entity’s activities are conducted on behalf of the limited partner (i.e., because it has up to a 99% investment in the partnership). However, we do not believe the size of the investment alone is determinative in assessing whether substantially all of the entity’s activities are conducted on behalf of the investor with disproportionately few voting rights. Instead, the nature of the activities performed by the entity should be considered and compared with the activities performed by the investor as part of its ongoing operations to make this determination. In this case, because the partnership provides residential housing, and the limited partner is not engaged in that activity outside of the partnership, substantially all of the activities of the partnership are not being conducted on behalf of the limited partner with disproportionately few voting rights (i.e., the entity’s operations are not substantially similar in nature to the activities of the investor with disproportionately few voting rights). Accordingly, the entity is not a VIE pursuant to the Variable Interest Model’s anti-abuse clause.

7.4.3 Related party and de facto agent considerations

The term “investor” in Condition 1 refers to an individual investor, even if related parties hold variable interests in the potential VIE. However, for Condition 2, the term “investor” refers to the individual investor and its related parties and certain de facto agents.

When applying Condition 1 of the anti-abuse clause, the FASB intends for an individual investor to consider whether it has voting rights that are not proportional to its obligations to absorb the expected losses of the entity, its right to receive the expected residual returns or both. The first condition does not aggregate the voting rights or economic interests held by an investor’s related parties. However, when evaluating Condition 2, the FASB intends for an investor to treat activities of the entity that involve or are conducted on behalf of its related parties (and certain de facto agents) as if they involve or are conducted on behalf of the investor.

Illustration 7-48: Anti-abuse test – related party and de facto agent considerations

Oilco (an oil and gas exploration and production company), Refineco (a crude oil refining company and related party of Oilco), and Investco (an investment company), form an LLC to buy and sell chemical feedstocks commonly used in refining crude oil into various petroleum products. Oilco, Refineco and Investco receive economic interests in the LLC of 40%, 20% and 40%, respectively. Voting rights are shared equally between the three parties. The equity investment is deemed to be at risk and is sufficient to absorb the entity’s expected losses.
The LLC enters into a long-term contract to supply chemicals to Refineco. At inception of the entity, it is anticipated that sales to Refineco will constitute approximately two-thirds of the LLC’s revenues.

**Analysis**

Because Oilco shares voting rights equally with Investco and Refineco, its voting rights are disproportionate to its obligation to absorb expected losses or receive expected residual returns of the LLC through its equity ownership. The equity ownership and related voting rights held by Refineco are ignored for determining whether Oilco has disproportionately few voting rights.

Although the activities of the LLC (i.e., buying and selling chemical feedstocks used in crude oil refining) are not substantially similar in nature to Oilco’s own operations as an oil and gas exploration and production company, they are substantially similar to Refineco’s operations. As a crude oil refiner, Refineco commonly acquires chemical feedstocks for use in its refining operations. Because sales of chemical feedstocks to Refineco will constitute approximately two-thirds of the LLC’s revenues, the activities of the LLC are deemed to be substantially on behalf of a related party of the investor (Oilco) with disproportionately few voting rights. Accordingly, the LLC is a VIE.

When applying the anti-abuse clause, an investor’s related parties include de facto agents, as that term is defined in ASC 810-10-25-43, except for de facto agents identified by ASC 810-10-25-43(d). The anti-abuse clause was designed to prevent a reporting entity from avoiding consolidation of a VIE by organizing the entity with non-substantive voting interests. If the investor were to aggregate its interests in the entity with certain de facto agents, the anti-abuse clause might have identified certain entities as VIEs that the FASB did not intend to be VIEs. Therefore, the FASB excluded only the de facto agents described in paragraph (d) of ASC 810-10-25-43. Under ASC 810-10-25-43(d), a party is a de facto agent of a reporting entity if that party has an agreement that it cannot sell, transfer or encumber its interests in an entity without the prior approval of the reporting entity because the agreement constrains the party from being able to manage the economic risks or realize the economic rewards of its interests in the entity. 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 (see Chapter 10).

**Illustration 7-49: Anti-abuse test – exclusion of certain de facto agents**

A limited partnership is formed to develop commercial real estate. A real estate development company, Restco, identifies the site for the project, does pre-construction development work, syndicates the partnership interests and serves as the general partner. As general partner, Restco is responsible for completing construction of the project and maintaining and operating the project once constructed. Restco holds a 20% interest in the partnership, and Investco holds the remaining 80% limited partnership interest. Investco is not actively involved in real estate development and holds its interest for investment purposes only. As is common in a limited partnership, Investco is restricted to protective voting rights (as that term is defined in the Variable Interest Model) in the partnership.

Under the terms of the partnership agreement, Restco is constrained from being able to realize the economic benefits of its interest in the partnership by sale, transfer or encumbrance without the prior approval of Investco. Investco does not have a similar restriction. Investco sought this provision to ensure that a qualified, reputable real estate developer will always be the general partner of the partnership. However, assume that pursuant to the provisions of ASC 810-10-25-43(d), Restco is deemed to be a de facto agent of Investco.
Analysis

The first condition of the anti-abuse clause is met because Investco has disproportionately few voting rights compared with its 80% limited partnership interest. If Investco were required to include Restco’s interest with its own because of the de facto agent relationship, the second condition also would be met because the activities of the partnership (the development of commercial real estate) are substantially similar to the activities of Restco. However, an investor is not required to aggregate its interest with de facto agents identified under paragraph (d) of ASC 810-10-25-43 when applying the second condition of the anti-abuse clause. Under paragraph (d) of ASC 810-10-25-43, a party is a de facto agent of a reporting entity if that party has an agreement that it cannot sell, transfer or encumber its interests in an entity without the prior approval of the reporting entity because the agreement constrains the party from being able to manage the economic risks or realize the economic rewards of its interests in the entity.

Therefore, the second condition has not been met because the activities of the partnership are substantively similar to the activities of Restco, which does not have disproportionately few voting rights. In this case, the entity is not a VIE pursuant to the anti-abuse clause.

Illustrative examples

<table>
<thead>
<tr>
<th>Illustration 7-50: Anti-abuse test</th>
</tr>
</thead>
</table>

**Example 1**

Automobile Manufacturing Corp. (AMC) established an entity with Investor Big Bucks (IBB). The sole purpose of the entity is to purchase automobiles manufactured by AMC and to sell them to various car dealerships in New York, New Jersey and Connecticut. AMC contributed automobiles with a fair value of $200 million to the entity, and IBB contributed $100 million in exchange for a 50% share of the entity. The $100 million was distributed to AMC at inception. AMC and IBB share 50/50 in all decision making activities. Any major decisions (as defined in the operating agreement) that cannot be made because the parties cannot agree are to be submitted to binding arbitration. Profits and losses are shared pro rata until the investors achieve an IRR on their investments of 12%, at which point AMC receives 60% of the entity’s profits. It is expected that the entity will generate profits to activate this allocation.

**Analysis**

AMC has disproportionately few voting rights compared with its right to receive expected residual returns. However, it is possible that AMC could conclude that substantially all of the entity’s activities are not being conducted on its behalf because the entity has the ability to sell automobiles to entities other than AMC dealerships. Under that view, the entity is not a VIE. However, careful consideration of the facts and circumstances regarding the purpose and design of the entity is necessary. This could result in a different conclusion.

**Example 2**

Assume the same facts as in Example 1, except that the entity is required to sell all of its automobiles to AMC-owned automobile dealerships.

**Analysis**

AMC has disproportionately few voting rights compared with its right to receive expected residual returns. Because the entity is limited to purchasing all of its automobiles from AMC and is limited to selling them to AMC dealerships, all of its activities involve or are conducted on behalf of AMC. Accordingly, both conditions of the anti-abuse clause are met, and the entity is a VIE.
Example 3

Assume the same facts as in Example 1, except that (1) AMC contributed $100 million for its share of the entity, (2) the entity initially purchased automobiles from Detroit Auto, an unrelated third party and (3) the entity is not limited to purchasing automobiles from AMC on an ongoing basis.

Analysis

AMC still has disproportionately few voting rights compared with its right to receive expected residual returns. However, because the entity is not limited to buying or selling automobiles directly with AMC, substantially all of its activities are not involving or conducted on behalf of AMC. Because the second condition of the anti-abuse clause is not met, the anti-abuse clause is not violated.

Example 4

Assume the same facts as in Example 1, except that certain decisions (as defined in the operating agreement) that constitute elements of power are to be made solely by AMC.

Analysis

IBB has disproportionately few voting rights on significant decisions to be made by the entity compared with its obligation to absorb expected losses and right to receive expected residual returns of the entity. However, because the entity’s activities are not substantially on behalf of IBB, the second condition of the anti-abuse clause is not met, and the anti-abuse clause is not violated.

7.5 Initial determination of VIE status

Excerpt from Accounting Standards Codification

Consolidation — Overall

Recognition — Variable Interest Entities

810-10-25-37

The initial determination of whether a legal entity is a VIE shall be made on the date at which a reporting entity becomes involved with the legal entity. For purposes of the Variable Interest Entities Subsections, involvement with a legal entity refers to ownership, contractual, or other pecuniary interests that may be determined to be variable interests. That determination shall be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements.

A reporting entity should make the initial determination of whether an entity is a VIE on the date on which it becomes involved with the entity, which generally is when it obtains a variable interest (e.g., an investment, loan or lease) in the entity. When making this determination, a reporting entity should consider the circumstances that exist at the date of the assessment, including future changes that are required by existing governing documents or contractual arrangements. A reporting entity should not consider changes to an entity’s governing documents or contractual arrangements that are anticipated but not required. This concept is included, in part, to ensure that variability in an entity’s returns (i.e., expected losses and expected residual returns) is not ascribed to a reporting entity that does not hold a variable interest at the date of the initial assessment.
Illustration 7-51: Changes in an entity's design or activities

Hardco, a manufacturer of computer hardware, provides subordinated debt financing to a software company, Softco. At the date of the loan, Softco’s equity investment at risk is insufficient to absorb its expected losses and, consequently, it is determined to be a VIE.

Within six months of the origination of the loan, Softco is expected to complete development of and launch a new software product that Hardco and other hardware manufacturers will sell to end users. This will represent a new market for Softco and is expected to result in higher, and more stable, revenues than sales of Softco’s existing products. In connection with the launch of the new software product, Softco is expected to restructure its operations, including a workforce reduction, and discontinue the sale of certain existing software products. Additionally, upon launch of the new software product, Softco is expected to complete a private placement of equity securities. It is anticipated that after these events occur, Softco will no longer be a VIE.

Analysis

Hardco should evaluate Softco based on the circumstances existing as of the date of the loan, without regard to anticipated future changes in Softco’s capitalization or activities. Therefore, on the date of the initial assessment Softco is a VIE. Hardco would have to apply the Variable Interest Model’s provisions to determine whether it is the primary beneficiary of Softco.

However, if certain anticipated events occur in the future (e.g., the anticipated equity issuance), it may be appropriate for Hardco to reassess whether Softco is a VIE at that time (see Chapter 11 for reconsideration events).

Illustration 7-52: Changes in an entity's design or activities

A partnership is formed to construct and operate a commercial office building. A construction loan is obtained during the construction phase of the project, and permanent financing is expected to be obtained upon completion of the project. The construction loan is anticipated to be repaid from the proceeds of that permanent financing.

Analysis

The parties involved with the partnership should initially determine whether the partnership is a VIE based only on the contractual arrangements in place at inception of the entity. That is, the parties involved should not assume that the permanent financing will be obtained and that the construction loan will be repaid. The parties should reconsider whether the partnership is a VIE when the construction loan is repaid and the permanent financing is obtained because the contractual arrangements among the parties involved will change at that date (see Chapter 11 for reconsideration events).
Primary beneficiary determination

8.1 Introduction

Excerpt from Accounting Standards Codification

Consolidation — Overall

Recognition — Variable Interest Entities

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.

810-10-25-38A

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.

A reporting entity must evaluate whether it is the primary beneficiary of a VIE if it concludes that (1) it is in the scope of the Variable Interest Model, (2) it has a variable interest in an entity and (3) the entity is a VIE. The primary beneficiary must consolidate the VIE.

The primary beneficiary analysis is a qualitative analysis based on power and benefits. A reporting entity has a controlling financial interest in a VIE and must consolidate the VIE if it has both power and benefits — that is, it has (1) the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance (power) 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 potentially could be significant to the VIE (benefits).
While the concepts of “power” in the Variable Interest Model and “control” in the Voting Model are similar, the two concepts are not synonymous. Under the Voting Model, there is no requirement to identify which activities are most significant. Instead, there is a rebuttable presumption that the majority owner has the unilateral ability to make decisions about all of the significant activities. See Appendix C for further guidance on the Voting Model.

Under the Variable Interest Model there is a requirement to identify which activities are most significant. In determining the primary beneficiary of a VIE, a reporting entity must identify which party has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Not all activities of an entity have a significant impact on the economic performance of the entity. Therefore, the concept of power requires a reporting entity to identify which activities most significantly impact a VIE’s economic performance and which party has the ability to make the decisions about those activities. We believe that the significant activities a reporting entity identifies when determining the primary beneficiary of a VIE should be the same activities that it used when determining whether the entity was a VIE (see Section 7.3.1.2). However, the focus is now on identifying which party has the power. The party with power may or may not be an equity holder.

**Question 8.1**

Is the primary beneficiary of a VIE the reporting entity that absorbs a majority of the VIE’s expected losses or receives a majority of the VIE’s expected residual returns or both?

No. Some mistakenly focus on economics when trying to determine whether a reporting entity is the primary beneficiary of a VIE. Under FIN 46(R), the primary beneficiary test was quantitative. A reporting entity would consolidate a VIE if it had a variable interest (or combination of variable interests) that would absorb a majority of the VIE’s expected losses, receive a majority of the VIE’s expected residual returns or both. However, ASU 2009-17 amended the primary beneficiary test to make it a qualitative assessment that focuses on power and benefits. While a reporting entity still considers economics (i.e., the obligation to absorb losses or the right to receive benefits), the primary beneficiary is the party with power. The FASB believes that a qualitative approach that focuses on power and benefits is more effective for determining the primary beneficiary of a VIE. An evaluation under this approach requires the use of significant judgment.

**8.2 Power**

To consolidate an entity under the Variable Interest Model, a reporting entity must have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. It is critical for a reporting entity to establish a disciplined approach to evaluate the power criterion. The following graphic helps to illustrate how to think systematically about the power assessment:
8.2.1 Step 1: Consider purpose and design

In evaluating the power criterion, a reporting entity first should consider the purpose and design of the VIE and the risks that the VIE was designed to create and pass to its variable interest holders. In evaluating purpose and design, a reporting entity should consider the nature of the entity’s activities, including which parties participated significantly in the design or redesign of the entity, the terms of the contracts the entity entered into, the nature of interests issued and how the entity’s interests were marketed to potential investors. The entity’s governing documents, marketing materials and contractual arrangements are often helpful in determining the risks the entity was designed to create and distribute.

See Chapter 5 for guidance on evaluating the purpose and design of an entity and the risks that an entity is designed to create and pass to its variable interest holders.

8.2.1.1 Involvement with the design of the VIE

Excerpt from Accounting Standards Codification
Consolidation – Overall
Recognition – Variable Interest Entities
810-10-25-38F

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.

In ASC 810-10-25-38F, the FASB emphasized that a reporting entity needs to assess its involvement in the design of an entity when determining whether it is the primary beneficiary. However, a reporting entity’s involvement in the design of a VIE does not automatically establish the reporting entity as the party with the power, even if its involvement is significant. Instead, that involvement may indicate that the reporting entity had the opportunity and the incentive to establish arrangements that result in it being the variable interest holder with the power. Reporting entities that establish the decisions that are encompassed in the governing documents of an entity need to be scrutinized more carefully to determine whether they have power, especially if they have potentially significant explicit or implicit variable interests. Consider a sponsor’s implicit agreement to fund an entity’s losses to protect its reputation. Because of its implicit financial responsibility, the sponsor may have an incentive to establish itself as the party with power to ensure that the entity operates as designed.

8.2.2 Step 2: Identify the activities that most significantly impact the VIE’s economic performance

Excerpt from Accounting Standards Codification
Consolidation – Overall
Recognition – Variable Interest Entities
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.
A reporting entity must identify which activities most significantly impact the VIE’s economic performance. We believe that the activities a reporting entity identifies to determine the primary beneficiary of a VIE should be the same activities it used when determining whether the entity was a VIE (see Section 7.3.1.2). However, the focus is now on identifying which party has the power. The party with power may or may not be an equity holder.

While a VIE’s operations may involve a number of activities, generally a subset of those activities is considered significant to the VIE’s economic performance. In assessing which activities are significant to a VIE’s economic performance, a reporting entity should consider how the activities affect the VIE’s fair value, revenues, expenses, margins, gains and losses, cash flows or financial position. Examples of significant activities include, but are not limited to, purchasing or selling significant assets, incurring additional indebtedness, making acquisition and/or divestiture decisions or determining the strategic operating direction of the entity. The significant activities identified may differ by the type of entity being evaluated.

It is important to note that a reporting entity's ability to direct the activities of a VIE when circumstances arise or events occur constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity also does not have to actively exercise its power to direct the activities of a VIE. To illustrate, in many receivable securitization structures, the securitization’s economic performance is affected most significantly by the performance of its underlying assets. Generally, the investors are exposed to the credit risk associated with the possible default by the underlying borrowers on principal and interest payments. Therefore, if the purpose and design indicate that the entity’s most significant activity is to manage the assets if they become delinquent, the reporting entity may determine that the party with the ability to manage the entity’s assets upon default is the primary beneficiary. While defaults may not have occurred yet and the party may not have exercised its power, the party that has the current right to make these decisions has the power.

While the provisions of ASC 810-10-25-38B apply to all arrangements, we believe that these provisions may be more relevant to entities in which decision-making is limited.

Question 8.2 Are there entities that have no substantive decision-making (i.e., entities on “auto-pilot”)?

We believe that there are few entities for which there is no substantive decision-making. That is, we believe that virtually all entities have some level of decision-making and that few, if any, are on “auto-pilot.” However, entities with limited decision-making require additional scrutiny to determine which party has the power. In doing so, careful consideration is required regarding the purpose and design of the entity. In addition, the evaluation of power may require an analysis of the decisions made at inception of the entity, including a review of the entity’s governing documents, because the activities at formation may affect the determination of power. For entities with a limited range of activities, such as certain securitization entities or other special-purpose entities, we believe that power should be determined based on how that limited range of activities was established and directed.

For entities with limited decision-making, the following considerations may be relevant:

- A reporting entity’s ability to direct the activities of a VIE only when specific circumstances arise or events occur may constitute power if that ability relates to the activities that most significantly impact the economic performance of the VIE.
- A reporting entity does not actively have to exercise its power in order to have the power to direct the activities of an entity.
- Involvement in the design of an entity may indicate that a reporting entity had the opportunity and incentive to establish arrangements that result in the reporting entity being the party with the power.
The greater the reporting entity's obligation to absorb losses or receive benefits, the more likely that it would be incentivized to have the power over the entity. Accordingly, a conclusion that a reporting entity with the obligation to absorb significant losses or the right to receive significant benefits does not have power should be carefully evaluated.

**Question 8.3** Should the activities that represent power be only those that significantly impact the economic benefits absorbed by the equity holders, or those that significantly impact the economic benefits absorbed by all variable interest holders?

In evaluating the power criterion, a reporting entity first should consider the purpose and design of the VIE to identify the risks that the VIE was designed to create and pass to all its variable interest holders. This includes considering the nature of all variable interests issued and how the entity's interests were marketed to potential investors. To assess power, a reporting entity must identify which activities most significantly impact the VIE's economic performance. While the Variable Interest Model does not define "economic performance," it does indicate that the evaluation of power is with respect to the entity's economic performance. Therefore, in evaluating the power criterion, all activities that most significantly impact the entity's economic performance should be considered regardless of which variable interest holder(s) absorb the economic benefits related to the activities.

**8.2.3 Steps 3 and 4: Identify how decisions about significant activities are made and the party or parties that make them**

After the activities that most significantly impact the VIE's economic performance have been identified, a reporting entity should identify how decisions about the significant activities are made and evaluate whether it has power to direct those activities. Power may be exercised through the voting rights of the equity holders, the board of directors (on behalf of the equity holders), a management contract, other arrangements or a combination of these factors. In evaluating whether a reporting entity is the primary beneficiary of a VIE, a reporting entity first determines whether it has power and benefits. If the reporting entity has both power and benefits, it consolidates the entity under the Variable Interest Model and does not evaluate the related party provisions of the Variable Interest Model (i.e., ASC 810-10-25-44B). For example, a reporting entity may decide there are four activities that most significantly impact a VIE's economic performance. If the reporting entity has the power to direct those activities (and has benefits), it is the primary beneficiary of the VIE.

In the following illustrations, we summarize some of examples in ASC 810 that explain how to identify the activities that most significantly impact a VIE's economic performance and the party or parties that make the decisions about those activities. See ASC 810-10-55-93 through 55-205 for all examples in their entirety.

**Illustration 8-1: Power – securitization**

Assume a VIE is financed with debt and equity and uses the proceeds from its financing to purchase commercial mortgage loans from a Transferor. The primary purpose for which the entity was created was to (1) provide liquidity to the Transferor and (2) provide investors with the ability to invest in a pool of commercial mortgage loans. The entity was marketed to debt investors as an entity that would be exposed to the credit risk associated with the possible default by the borrowers on principal and interest payments.

The Transferor retains primary servicing responsibilities, which 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 to the Special Servicer (the equity holder). The Special Servicer, as the equity holder, also has the right to approve budgets, leases and property managers of foreclosed properties.
Analysis

The economic performance of the entity is affected most significantly by the performance of its underlying assets. Therefore, the Special Servicer’s ability to manage the entity’s assets that are delinquent or in default provides the Special Servicer with the power.

Illustration 8-2: Power — asset-backed collateralized debt obligation

Assume a VIE is financed with debt and equity and uses the proceeds from its financing to purchase a portfolio of asset-backed securities with varying tenors and interest rates. The Manager holds 35% of the equity tranche, and a third-party investor holds 65%. The entity was created primarily to (1) provide investors with the ability to invest in a pool of asset-backed securities, (2) earn a positive spread between the interest that the entity earns on its portfolio and the interest paid to debt investors and (3) generate management fees for the Manager. The entity 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 and to the interest rate risk associated with the active management of the portfolio.

The parameters established by the underlying trust documents provide the Manager with the latitude to manage the entity’s assets while maintaining an average portfolio rating of single B-plus or higher. If the average rating of the portfolio declines, the entity’s governing documents require that the Manager’s discretion in managing the portfolio be curtailed. The third-party equity investor has rights that are limited to administrative matters.

Analysis

The economic performance of the entity is affected most significantly by the performance of the entity’s portfolio of assets. Therefore, the Manager’s ability to manage the entity’s assets within the parameters of the trust documents provides the Manager with the power.

Illustration 8-3: Power — lease

Assume a VIE is financed with five-year fixed-rate debt and equity. It uses the proceeds from its financing to purchase property to be leased to a lessee with an AA credit rating. The lease has a five-year term and is classified as a direct finance lease by the lessor and as an operating lease by the lessee. However, the lessee is considered the owner of the property for tax purposes and, thus, receives tax depreciation benefits. Additionally, the lessee is required to provide a first-loss residual value guarantee for the expected future value of the leased property at the end of the five years (the option price) up to a specified percentage of the option price, and it has a fixed-price purchase option to acquire the property for the option price. If the lessee does not exercise the fixed-price purchase option at the end of the lease term, the lessee is required to remarket the property on behalf of the entity. The lessee is entitled to the excess of the sales proceeds over the option price.

The primary purpose for which the VIE was created was to provide the lessee with the use of the property for five years with substantially all of the rights and obligations of ownership, including tax benefits. The entity was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by leased property that would provide a fixed-rate return to debt holders equivalent to AA-rated assets. The return to the equity investors is expected to be slightly greater than the return to the debt investors because the equity is subordinated to the debt. The residual value guarantee transfers substantially all of the risk associated with the underlying property to the lessee, and the fixed-price purchase option effectively transfers substantially all of the rewards from the underlying property to the lessee. The entity is designed to be exposed to the risks associated with a cumulative change in fair value of the leased property at the end of five years as well as credit risk related to the potential default by the lessee of its contractually required lease payments.
Analysis

The governing documents for the entity do not permit the entity to buy additional assets or sell existing assets during the five-year holding period, and the terms of the lease agreement and the governing documents for the entity do not provide the equity holders with the power to direct any activities of the VIE. The economic performance of the VIE is significantly affected by the fair value of the underlying property and the credit of the lessee. The lessee’s maintenance and operation of the leased property has a direct effect on the fair value of the underlying property, and the lessee directs the remarketing of the property. Therefore, the lessee has the power.

When determining the primary beneficiary of a VIE, it is possible for a reporting entity to be the primary beneficiary of a VIE without having the power to direct all of the activities that most significantly impact a VIE’s economic performance. ASC 810-10-25-38E indicates that if the power rests with multiple unrelated parties, and the nature of the activities that each party is directing is not the same, a reporting entity should identify which party has the power over the activities that are most significant (see Section 8.2.3.6).

8.2.3.1 Related party considerations

In evaluating whether a reporting entity is the primary beneficiary of a VIE, a reporting entity first determines whether it has power and benefits. If a reporting entity concludes that it does not have power and benefits, it should determine whether another party has power and benefits. Another party could individually have power and benefits and be the primary beneficiary of a VIE. However, if a reporting entity concludes that no party individually is the primary beneficiary but that, as a group, the reporting entity and its related parties have the characteristics of a primary beneficiary, the reporting entity must consider the Variable Interest Model’s related party provisions to determine if one party is the primary beneficiary (see Chapter 9). For the Variable Interest Model, the term related parties includes parties identified in ASC 850 and certain other parties that act as de facto agents of the variable interest holder (see Chapter 10).

8.2.3.2 Situations in which no party has the power over a VIE

In some circumstances, a reporting entity may conclude that no one party has the power over a VIE. The following are situations in which no party has the power over a VIE (this list is not all-inclusive):

- Power is shared among unrelated parties such that mutual consent of each party sharing power is required to make the decisions that most significantly impact the economic performance of the entity (see Section 8.2.3.3).

- Power is conveyed through the board of directors of an entity, and no one party controls the board of directors (see Section 8.2.3.4).

- Power is not shared, but the activities that most significantly impact the VIE’s economic performance are directed by multiple unrelated parties, with each party directing the same activities, and no party has the power over the majority of the activities (see Section 8.2.3.5).

In each of the above circumstances, if a reporting entity has a related party or de facto agent with involvement in a VIE, it will be necessary for the reporting entity to evaluate the related party provisions of the Variable Interest Model to determine which party, if any, should consolidate.
8.2.3.3 Shared power

**Excerpt from Accounting Standards Codification**

Consolidation – Overall

Recognition – Variable Interest Entities

810-10-25-38D

If a reporting entity determines that power is, in fact, shared among multiple unrelated parties such that no one party has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance and if decisions about those activities require the consent of each of the parties sharing power. If a reporting entity concludes that power is not shared but the activities that most significantly impact the VIE’s economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities shall be considered to have the characteristic in paragraph 810-10-25-38A(a).

Power can be shared by a group of unrelated parties if the consent of each of the parties is required to make the decisions about the significant activities. A reporting entity would therefore determine that no single party has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. In making this determination, a reporting entity should evaluate the governance provisions of the entity to ensure that the consent provisions are substantive. For example, a reporting entity should consider what happens if consent is not given (e.g., remedies) and how those provisions may affect the determination of whether consent is substantive.

The SEC staff has indicated that it is skeptical of assertions that power is shared and focuses on whether the parties have demonstrated that power over the VIE’s significant activities is shared.21

**Illustration 8-4: Shared power**

Enterprise A, Enterprise B and Enterprise C are unrelated parties that form an entity, Ice Cream Co., to manufacture, distribute and sell ice cream. Each enterprise obtained 33.33% of the equity of Ice Cream Co. through equal contributions of cash upon formation of the entity. All profits and losses of Ice Cream Co. are allocated to the equity investors in proportion to their equity ownership. The enterprises hold no other variable interests in Ice Cream Co. besides their equity interests. There are no other variable interest holders in Ice Cream Co. Ice Cream Co. is determined to be a VIE.

Each enterprise can appoint one member to the board of directors. The board of directors hires a management team to carry out the day-to-day operations of the entity. All decisions related to Ice Cream Co.’s significant activities are taken to the board of directors and require the unanimous consent of all three directors.

---

Analysis

Ice Cream Co. does not have a primary beneficiary because no single party has the power to direct the activities that most significantly impact the economic performance of the entity. Since all decisions regarding the significant activities of Ice Cream Co. require approval of Enterprise A, Enterprise B and Enterprise C through their appointed directors, neither Enterprise A, Enterprise B nor Enterprise C can independently make decisions regarding Ice Cream Co.'s significant activities. In this case, no one consolidates Ice Cream Co.

However, if all three enterprises are related or have de facto agency relationships, one of the enterprises must be identified as the primary beneficiary because collectively they have power. The Variable Interest Model's related party provisions would be used to determine which enterprise is the primary beneficiary of the entity (see Chapter 9).

Question 8.4  Do shareholder rights with respect to the ability to break a tie affect the determination of which party has power?

In evaluating whether power is shared, it is critical to understand the mechanisms for remediating disputes among the equity holders (i.e., when the equity holders disagree and cannot make a significant decision). The shareholder or partnership agreement may include terms and conditions for the resolution of such disputes. If one equity holder has contractual or legal authority to break a tie (i.e., tie-breaking authority) on significant decisions, it may have power.

However, no equity holder would have power, for example, if the shareholder or partnership agreement calls for arbitration or for resolution via a separate, over-arching agreement among the owners.

8.2.3.4 Power conveyed through a board of directors and no one party controls the board

Another situation in which no party has the power over a VIE is when power is conveyed through a board of directors and no party controls the board.

Illustration 8-5:  Power conveyed through a board of directors and no one party controls the board

Example 1
Assume the same facts as in Illustration 8-4, except that decisions about Ice Cream Co.'s significant activities require approval by a two-thirds majority of the board of directors.

Analysis
The assessment of power would not differ from the conclusion in Illustration 8-4. Ice Cream Co. does not have a primary beneficiary because no single party has the power to direct the activities that most significantly impact the economic performance of the entity. Each enterprise has only one-third of the vote through its representation on the board of directors, and a vote of at least two-thirds of the directors is required. Therefore, no single party can independently make decisions about Ice Cream Co.'s significant activities. In this case, no one consolidates Ice Cream Co.
8.2.3.5 Multiple unrelated parties direct the same activities that most significantly impact the VIE’s economic performance

If a reporting entity concludes that power is not shared (as described in Section 8.2.3.3) but the activities that most significantly impact the VIE’s economic performance are directed by multiple unrelated parties, and each party directs the same activities, the party, if any, with the power over the majority of the activities is the primary beneficiary of the VIE (provided it has benefits). If no party has the power over the majority of the activities, there is no primary beneficiary.

We believe that this principle will not be applied frequently in practice because few entities have multiple parties performing the same activities without requiring the consent of others.

Illustration 8-6: Multiple unrelated parties direct the same activities

Assume two parties form a VIE to manufacture, distribute and sell beverages, with each holding an equity interest. Assume that each party manufactures, distributes and sells the beverages in different locations. Power is not shared because each party is not required to consent to the other’s decisions.

Analysis

Because each party directs the same activities, the party with the power over the majority of the activities is the primary beneficiary of the VIE. Determining which of these parties has power over the majority of the activities could prove difficult and will require a careful assessment of the facts and circumstances. In this example, because there are only two decision makers, we believe that one must have the power over a majority of the activities, and, therefore, one party must be identified as the primary beneficiary. That is, we believe it would be difficult to argue that each party directs exactly 50% of the activities after considering the relative size of the locations and other factors. However, if there are three or more decision makers, it is possible that no one party would have power over a majority of the activities (e.g., if no party had power over more than 50% of the decisions).

8.2.3.6 Multiple unrelated parties direct different activities that most significantly impact the VIE’s economic performance

Excerpt from Accounting Standards Codification

Consolidation — Overall
Recognition — Variable Interest Entities

810-10-25-38E

If the activities that impact the VIE’s economic performance are directed by multiple unrelated parties, and the nature of the activities that each party is directing is not the same, then a reporting entity shall identify which party has the power to direct the activities that most significantly impact the VIE’s economic performance. One party will have this power, and that party shall be deemed to have the characteristic in paragraph 810-10-25-38A(a).

If power is not shared but the activities that most significantly impact the VIE’s economic performance are directed by multiple unrelated parties, and each party directs different activities, a reporting entity must identify the party that has the power to direct the activities that most significantly impact the entity’s economic performance. That is, one party has the power. For example, a party may decide there are four decisions that most significantly impact a VIE’s economic performance. If one party makes two decisions and another party makes the other two decisions, the parties must effectively put the decisions on a scale and decide which party is directing the activities that most significantly impact the VIE’s economic performance. Determining which party is the primary beneficiary in these circumstances will require a reporting entity to evaluate the purpose and design of the entity and to consider other factors that may provide insight into which party has the power.
Illustration 8-7: Multiple unrelated parties direct the different activities

Manufacture Co. and Distribute Co. are unrelated parties that form an entity Soda Co. Manufacture Co. and Distribute Co. each contribute an equal amount of cash and receive a 50% equity interest in Soda Co. The purpose and design of Soda Co. is to manufacture, distribute and sell beverages in the U.S. Soda Co. is determined to be a VIE. Apart from their equity interest, neither Manufacture Co. nor Distribute Co. hold any other variable interests in Soda Co. Also, there are no other variable interest holders in Soda Co.

Analysis

First, Manufacture Co. should consider the purpose and design of Soda Co., including the risks the VIE was designed to create and pass along to its variable interest holders. Soda Co. was created to provide Manufacture Co. access to Distribute Co.’s distribution network while providing Distribute Co. new soda products to distribute and sell to its customers. Profits and losses of Soda Co. will be allocated equally to Manufacture Co. and Distribute Co. based on their equity interests.

Next, Manufacture Co. should identify the activities at Soda Co. that most significantly impact the economic performance of Soda Co. Manufacture Co. has identified three such activities, which are as follows:

<table>
<thead>
<tr>
<th>Significant activity</th>
<th>Responsible party</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>Manufacture Co.</td>
</tr>
<tr>
<td>Distributing</td>
<td>Distribute Co.</td>
</tr>
<tr>
<td>Selling</td>
<td>Distribute Co.</td>
</tr>
</tbody>
</table>

Next, Manufacture Co. must determine how decisions about the significant activities are made and which party or parties make those decisions. Manufacture Co. determines that the three significant activities are made pursuant to an operating agreement. The operating agreement provides that the party or parties responsible for making decisions about each of three activities is as follows:

<table>
<thead>
<tr>
<th>Significant activity</th>
<th>Responsible party</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>Manufacture Co.</td>
</tr>
<tr>
<td>Distributing</td>
<td>Distribute Co.</td>
</tr>
<tr>
<td>Selling</td>
<td>Distribute Co.</td>
</tr>
</tbody>
</table>

Because the activities that most significantly impact Soda Co.’s economic performance are directed by multiple unrelated parties, and each party directs different activities, either Manufacture Co. or Distribute Co. is the primary beneficiary. Determining which of these activities require decisions that most significantly impact Soda Co.’s economic performance could prove difficult and will require a careful assessment of the facts and circumstances. The primary beneficiary is not necessarily the reporting entity that directs a greater number of activities.

8.2.3.6.1 Different parties with power over the entity’s life cycle

In evaluating which party has power, a reporting entity should carefully consider the entity’s purpose and design. By design, power may shift between parties over time. Therefore, we believe that a reporting entity should consider which activities most significantly impact the economic performance of the entity over its remaining life as of the date of the assessment.

When power shifts at various stages of an entity’s life cycle, the determination of the primary beneficiary will require a careful analysis of the facts and circumstances. We believe that a reporting entity should evaluate the probability of successfully moving from one stage to the next and the nature of the different
stages. We generally believe that the greater the certainty of the completion of a stage, the more likely that a reporting entity would look beyond that stage and consider other stages of the entity’s life cycle. The length of a particular stage may be relevant to the primary beneficiary determination. Also, a reporting entity should carefully evaluate whether rights of certain parties to an arrangement constitute protective rights because protective rights do not convey power.

**Illustration 8-8: Different parties with power over the entity’s life cycle**

An entity is formed to develop and ultimately manufacture a highly speculative drug candidate. In assessing which activities most significantly impact the entity’s economic performance at its inception, a reporting entity determines that there are two primary activities – research and development (R&D) and manufacturing. One investor has power over the R&D activities. A second investor has power over the drug manufacturing if the R&D activities are successful and the drug receives FDA approval.

**Analysis**

We believe that determining which party has power at inception of the entity requires a consideration of the probability that the parties involved will have power through the different stages of the entity. The entity was designed to develop a drug candidate with the hope of ultimately manufacturing the drug for sale. However, in this fact pattern, there is significant uncertainty of the drug ever reaching the manufacturing stage. If the R&D activities are unsuccessful, the manufacturing of the drug will never occur. We believe that the party with the ability to direct the manufacturing decisions has a current right to obtain power that is contingently exercisable upon completion of the R&D phase. Therefore, we believe that the party with power over the R&D activities is the primary beneficiary at inception.

As the entity evolves, we believe that the primary beneficiary may change as characteristics and assumptions with respect to the entity change. For example, a reporting entity may conclude that once FDA approval of the drug candidate is received, the party with power over the entity’s manufacturing processes is the primary beneficiary.

**8.2.3.6.2 Evaluating rights held by the board of directors and an operations manager in an operating entity**

In many operating entities, the entity is governed by a board of directors with an operations manager performing certain day-to-day functions. In these circumstances, it may be challenging to determine whether the equity holders have power (through their representation on the board of directors) or whether the manager has power.

To illustrate, assume that an operating entity (a VIE) is formed by two unrelated equity investors to distribute a product to an unrelated third party. Each equity investor receives one seat on the entity’s board of directors, and all board decisions require a unanimous vote of the two board members. The two investors decide to hire an unrelated third party with distribution management experience to manage the day-to-day operations of the entity. Assume that the operations manager has a variable interest in the entity through the fees it receives as a manager because the fees are not commensurate with the level of effort required to provide the managerial services.

After giving consideration to the purpose and design of the entity, assume that there are three activities that most significantly impact the entity’s economic performance: financing decisions, capital decisions and operating decisions. The board of directors makes all financing and capital decisions and thus has power over those activities. The board of directors also approves the operating budget. However, the operations manager makes day-to-day decisions with respect to carrying out the operating budget and has certain latitude with respect to decisions including product procurement, product pricing, contract negotiation and hiring/firing employees. In these circumstances, determining whether the board of
directors has power over operating decisions (through the budgeting process) or whether the operations manager has power over operating decisions (through day-to-day management) requires judgment. In making this assessment, relevant considerations may include the following:

- The amount of detail set forth in the operating budget
- The frequency and manner in which a comparison of the budget to actual results is reviewed by the board of directors
- The ability for the budget to be changed
- The manner in which the budget is prepared and reviewed

If the budget is so detailed that it effectively constrains the operations manager's discretion, power over operating decisions may rest with the board of directors. An operating budget that includes budgeted sales by product type and budgeted costs by department is more likely to constrain the decision-making of an operations manager than a one-page operating budget that contains a single line for sales and a limited number of lines for expenses.

If the board reviews the budget frequently, such reviews may constrain the decision-making of the operations manager, indicating that power over operating decisions rests with the board of directors. A monthly comparison of the operating budget to actual results is more likely to constrain the operations manager than a review that occurs annually. Additionally, it is more likely that the board of directors would have power if protocols force the operations manager to report budget deviations of 1% rather than deviations of 20%.

The board's ability to make changes to the budget may suggest that power rests with the board of directors and that the activities of the operations manager are constrained by the budgeting process.

If the board of directors has significant involvement in preparing and reviewing the budget, it may be more likely that power over operating decisions rests with the board of directors. If the operations manager is responsible for the budget preparation, the involvement of the board of directors in the review process may provide insight into the party with power over operating decisions. For example, an on-site review process that spans multiple days and results in meetings with numerous management personnel might indicate that the budget process constrains the activities of the operations manager more than a review that takes place remotely with little or no contact with the operations manager.

Careful evaluation of the facts and circumstances of each arrangement will be necessary. While none of these considerations are individually or collectively determinative, they may be useful in evaluating power in similar arrangements.

Continuing with the illustration in which two unrelated investors form a VIE in which each holds a board seat and all board decisions require unanimous consent, if it is determined that the board of directors has power over the operating decisions, neither equity investor would have power over the entity. This is because all three activities that most significantly impact the entity’s economic performance (i.e., financing, capital and operating decisions) are made by the board of directors (on behalf of the equity investors) and no party controls the board.

On the other hand, if it is determined that power over operating decisions rests with the operations manager, further consideration is necessary to determine whether the operations manager would be the primary beneficiary. This is because one of the significant activities (i.e., operating decisions) is made by the operations manager and the other two significant activities (i.e., financing and capital decisions) are made by the board of directors. As described in Section 8.2.3.6, when the activities that most significantly impact the VIE’s economic performance are directed by multiple parties, and each party performs different activities, a reporting entity must identify the party that has the power to direct the
activities that most significantly impact the entity’s economic performance. If the operations manager
determined that the operating decisions that it makes are the activities that most significantly impact the
entity’s economic performance, it would consolidate the VIE.

8.2.4 Kick-out rights, participating rights and protective rights

Excerpt from Accounting Standards Codification

Consolidation — Overall

Recognition — Variable Interest Entities

810-10-25-38C

A reporting entity’s determination of whether it has the power to direct the activities of a VIE that most
significantly impact the VIE’s economic performance shall not be affected by the existence of kick-out
rights or participating rights unless a single reporting entity (including its related parties and de facto
agents) has the unilateral ability to exercise those kick-out rights or participating rights. A single
reporting entity (including its related parties and de facto agents) that has the unilateral ability to
exercise kick-out rights or participating rights may be the party with the power to direct the activities of
a variable interest entity that most significantly impact the entity’s economic performance. These
requirements related to kick-out rights and participating rights are limited to this particular analysis and
are not applicable to transactions accounted for under other authoritative guidance. Protective rights
held by other parties do not preclude a reporting entity from having the power to direct the activities of
a variable interest entity that most significantly impact the entity’s economic performance.

As part of its power assessment, a reporting entity also should consider whether kick-out rights,
participating rights or protective rights are present.

8.2.4.1 Kick-out rights

When kick-out rights are present in an arrangement, they should be considered in identifying which
party, if any, is the primary beneficiary of a VIE. It is important to note that, in the primary beneficiary
evaluation, kick-out rights must be held by a single party (including its related parties and de facto
agents) and must be substantive to be considered in the analysis. If more than one party has to come
together to exercise the right, it is not factored into the primary beneficiary analysis. Also, if the kick-out
right is not substantive, for example because of barriers to exercise, it is not factored into the analysis
(see Section 7.3.1.3.3 for further details about how to evaluate whether a kick-out right is substantive).
A substantive kick-out right held by a single party precludes the decision maker or service provider from
having power and may indicate that the party holding the kick-out right has the power.

Although we believe that the party with unilateral kick-out rights often will be the party with power, this
may not necessarily be the case. ASC 810-10-25-38C indicates that “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.” Determining whether a single
reporting entity that has the unilateral ability to exercise kick-out rights (or liquidation rights) is the party
with the power will require a careful evaluation of facts and circumstances. Considerations that may be
relevant in making this determination include the following:

- Other rights held by the holder of the kick-out rights
- Whether the holder of the kick-out rights has the ability to appoint the replacement to the party removed
- Whether the holder of the liquidation rights receives its relative share of the entity’s assets upon
  liquidation or receives a cash payment
Illustration 8-9: Unilateral kick-out right

Assume two unrelated parties (Party A and Party B) form an entity that is a VIE. The parties identify three activities (e.g., operating budget, capital expenditures and incurring debt) that most significantly impact the VIE's economic performance. Party A, the manager, is responsible for making decisions about all three significant activities, but Party B holds 100% of the equity and has a substantive kick-out right to remove and replace Party A as the manager without cause.

Analysis

We believe that Party B likely would be the primary beneficiary of the VIE and therefore would consolidate the VIE because Party B's unilateral kick-out right negates Party A's decision-making ability.

Question 8.5

Can a board of directors be viewed as a single reporting entity when evaluating whether one party has the unilateral ability to exercise kick-out rights?

No. We believe that a board of directors acts in a fiduciary capacity on behalf of the shareholders (i.e., the board of directors is an extension of the shareholders). Any kick-out right held by a board of directors essentially represents a kick-out right that is held by the shareholders. Therefore, unless one shareholder (and its related parties and de facto agents) has unilateral control over the board of directors, we believe that the kick-out rights held by the board of directors should not be considered when assessing which party is the primary beneficiary. We understand that the FASB staff and SEC staff share this view.

8.2.4.2 Participating rights

Like kick-out rights, participating rights should not affect the primary beneficiary determination unless a single party (including its related parties and de facto agents) has the ability to exercise such participating rights and the rights are substantive.

It's important to note that participating rights generally do not provide the holder of the rights with power but may preclude another party from having power. Significant judgment is required to distinguish a participating right from a protective right.

Illustration 8-10: Unilateral participating right

Assume two unrelated parties (Party A and Party B) form an entity that is a VIE. They identify three activities (e.g., operating budget, capital expenditures and incurring debt) as those that most significantly impact the VIE's economic performance. Party A is responsible for making decisions about all three significant activities, but Party B has participating rights over all three decisions (i.e., Party B has the ability to block each of the three significant decisions made by Party A).

Analysis

We believe that the participating rights do not provide Party B with power over the VIE but likely would preclude Party A from having the power. In this case, it is possible that neither party would consolidate the VIE.

However, if Party B had participating rights over two of the three decisions but Party A had the unilateral right to direct the third significant activity, we believe Party A would have the power and therefore would consolidate the VIE.
Question 8.6  If a reporting entity holds only participating rights, can it be the primary beneficiary of a VIE?

No. Participating rights are defined in the Variable Interest Model as “the ability to block or participate in the actions through which a reporting entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.” We do not believe that a reporting entity’s ability to block actions provides the reporting entity with power over those same actions. Thus, a reporting entity that only holds participating rights over the decisions that otherwise constitute power would not have both power and benefits by virtue of the participating rights. However, if a reporting entity has other rights, careful consideration will be required to evaluate the combination of those rights and the participating rights in the primary beneficiary analysis because the reporting entity could be considered the primary beneficiary in those circumstances. For example, assume a reporting entity identifies the population of decisions that most significantly impacts a VIE’s economic performance. Assume that the reporting entity has participating rights with respect to each of those decisions, except for decisions related to financing and asset transfers, which the reporting entity has the unilateral ability to direct. In this scenario, we believe that the reporting entity likely would be deemed the primary beneficiary of the VIE.

A reporting entity that holds only participating rights also should carefully consider whether any of its related parties have a variable interest in the VIE and participate in decision making. If so, the reporting entity and its related parties, as a group, may have both power and benefits. In which case, the parties in the group are required to analyze the related party provisions of the Variable Interest Model to determine if one party is the primary beneficiary of the entity (see Chapter 9).

8.2.4.3  Protective rights

Under the Variable Interest Model, protective rights are designed only to protect the interests of the party holding those rights. These rights do not provide the holder of such rights with power and do not preclude another reporting entity from having the power.

Question 8.7  How should a reporting entity distinguish between power exercisable upon the occurrence of future events and protective rights?

In certain circumstances, a reporting entity’s ability to direct the activities of an entity when circumstances arise or events happen may constitute power. However, protective rights do not constitute power and do not preclude another reporting entity from having power.

To illustrate, assume that a special servicer in a receivable securitization has the ability to manage the entity’s assets when the receivables become delinquent or are in default. The rights of the special servicer are current rights over decisions that are expected to occur and are necessary for the entity to carry out its purpose and design. Therefore, these rights would be relevant in the assessment of which party has the power, and, in many cases, the special servicer will be the primary beneficiary. Alternatively, a lender to the servicing arrangement may have the right to remove the servicer upon the servicer’s breach of contract and to take over the servicing responsibilities. This type of right generally would not be viewed as a current right because the servicer’s breach of contract most likely would not have been contemplated in the purpose and design of the entity. The right may be included in the arrangement to protect the debt provider in the event of an exceptional circumstance. Thus, this protective right should not be considered in the determination of the primary beneficiary of the securitization facility.
In some circumstances, it may be difficult to distinguish between power and protective rights. In these instances, we believe that it will be particularly important to consider the purpose and the design of the VIE. It may be helpful to distinguish between those decision-making rights that relate to activities that are expected to arise for the entity to carry out its purpose and design versus contingent rights that are triggered upon events that arise outside the purpose and design of the entity, or upon an exceptional circumstance. The latter type of contingent rights often may be thought of as protective rights and may result in a reporting entity obtaining power if a future event occurs, but would not necessarily represent current power.

8.2.4.4 Potential voting rights (e.g., call options, convertible instruments)

The Variable Interest Model does not specifically address potential voting rights. However, we generally do not believe that the existence of a potential voting right alone provides its holder with power. While potential voting rights should be considered in the evaluation of an entity's purpose and design and in the evaluation of power, an arrangement that provides a reporting entity with a potential voting right generally does not give that reporting entity the power over the most significant activities of a VIE when decisions about those activities need to be made. Rather, such a right provides the holder with an economic benefit that potentially includes an opportunity to obtain power at a future date. Consequently, the holder of a potential voting right has power only when another incremental contractual right gives the holder power. However, the exercise of a potential voting right would require reconsideration of the primary beneficiary of a VIE. We understand that the FASB staff shares these views.

Consistent with these views, we generally do not believe that an instrument that is contingently exercisable or a forward contract should be included in the analysis of power until it is exercised or settled.

In certain circumstances, the terms and conditions of a potential voting right (e.g., a fixed-price call option that is deep in the money with little economic outlay required to exercise it) may require further consideration to determine whether the substance of the potential voting right conveys power to the holder. For example, if at inception of an arrangement, a reporting entity acquires fixed-priced call options to purchase shares of an entity for $1 when the per-share price of the entity is $200, it should consider the purpose and design of the entity and the arrangement to evaluate whether the call option conveys power to the reporting entity.

8.3 Benefits

In addition to having power, the primary beneficiary of a VIE must have benefits—that is, the obligation to absorb losses of the VIE that potentially could be significant to the VIE or the right to receive benefits from the VIE that potentially could be significant to the VIE. Benefits can be current benefits or future benefits.

If a reporting entity has concluded that it has a variable interest, it likely will meet the benefits criterion. If a reporting entity has a variable interest in a VIE, we believe there is a presumption that the reporting entity has satisfied the benefits criterion. We believe that it would be uncommon for a reporting entity to conclude that it has a variable interest but does not have benefits, except when the variable interest is a fee that is customary and commensurate (because a fee that is customary and commensurate is excluded from the benefits criterion, as discussed in Section 8.3.1). Having a variable interest generally will expose a reporting entity to either losses or returns that potentially could be significant to the VIE.

The key phrase in this analysis is “could be significant.” The FASB’s use of this phrase implies that the threshold is not “what would happen,” but “what could happen.” We believe that the assessment of significance contemplates possible outcomes over the life of the entity and a consideration of the likelihood or probability of the outcome generally is not relevant for this assessment. Accordingly, a reporting entity would meet the “benefits” criterion if it could absorb significant losses or benefits, even if the events that would lead to such losses or benefits are not expected. That is, a reporting entity would
meet the “benefits” criterion if it could absorb significant losses or benefits in remote (yet possible) scenarios. The FASB did not provide additional guidance or a bright-line rule on determining whether a reporting entity has satisfied the benefits criterion.

Although the primary beneficiary must have both power and benefits, it does not have to have both the obligation to absorb losses and the right to receive benefits. The primary beneficiary only has to be exposed to one or the other. For example, if a reporting entity has power and has provided a significant guarantee on assets or obligations of the VIE, it is the primary beneficiary even though it may not be entitled to receive any “upside.” Similarly, if a reporting entity has power and has the right to receive “upside” but has no obligation to absorb losses, it is the primary beneficiary.

In evaluating whether a reporting entity has satisfied the benefits criterion, the use of professional judgment will be required. A reporting entity should consider all facts and circumstances regarding the terms and characteristics of the variable interest(s), the design of the VIE and the other involvements of the reporting entity with the VIE.

Question 8.8  Must the primary beneficiary of a VIE have a variable interest in the VIE?

Yes. The Variable Interest Model indicates that “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 ASC 810-10-25-38A through 25-38J” [emphasis added]. Additionally, paragraph A42 of FAS 167's Basis for Conclusions states, “a party cannot be the primary beneficiary of an entity if that party does not hold a variable interest in the entity.” Therefore, if a reporting entity does not have a variable interest in an entity, we believe that the reporting entity is not required to evaluate the provisions of the Variable Interest Model further to account for its interest. This includes determining whether the reporting entity is the primary beneficiary of the entity and whether the reporting entity is subject to the disclosure provisions of the Variable Interest Model.

In addition, we believe that a reporting entity must receive power through a variable interest or a combination of variable interests. If, for example, a reporting entity has power, but its power does not come through a variable interest (e.g., a decision-maker fee that does not meet the criteria in ASC 810-10-55-37 to 55-37D and 55-38 to be a variable interest), the reporting entity would conclude that it is not the primary beneficiary (see Question 5.4).

8.3.1  Fees paid to decision makers or service providers

Excerpt from Accounting Standards Codification

Consolidation – Overall

Recognition – Variable Interest Entities

Consolidation Based on Variable Interests

810-10-25-38H

For purposes of evaluating the characteristic in paragraph 810-10-25-38A(b), fees paid to a reporting entity (other than those included in arrangements that expose a reporting entity to risk of loss as described in paragraph 810-10-25-38J) that meet both of the following conditions shall be excluded:

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

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

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

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

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:

- 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 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.

To determine whether a reporting entity satisfies the benefits criterion, it will exclude fee arrangements that meet both of the following conditions:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The compensation arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated on an arm's-length basis.

The FASB believes that fee arrangements that meet these conditions differ from other types of variable interests because they do not expose the reporting entity to losses and, therefore, reflect an agent role. Further, the FASB believes that upside and downside risks are linked and that the opportunity to receive benefits always creates some risk. When evaluating whether a reporting entity has the right to receive benefits or the obligation to absorb losses that could potentially be significant the FASB gives greater priority to variable interests that provide both benefits and losses.

A fee arrangement would not presumptively fail these conditions only because it relates to unique or new services or because it reflects a change in what is considered customary and commensurate. However, in those instances, we believe that determining whether a fee arrangement meets the conditions above will require judgment.
Fees arrangements that expose a decision maker or service provider to risk of loss in the VIE should not be considered when evaluating the benefits criterion. Such arrangements are deemed to give a reporting entity the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

Examples of fees that could expose a reporting entity to loss include fees related to the following:

- Guarantees
- Obligations to fund operating losses
- Payments associated with written put options on the assets of the VIE
- Liquidity commitments and similar obligations (explicit or implicit) that protect holders of other interests from suffering losses in the VIE

### 8.3.2 Evaluating disproportionate power and benefits

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Recognition — Variable Interest Entities**

**810-10-25-38G**

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.

We believe that the greater a reporting entity’s exposure to benefits, the more incentivized the reporting entity would be to obtain power over an entity. In other words, most reporting entities would not be willing to accept a high level of economic risk in an entity without having power. However, this provision of the Variable Interest Model is not determinative. Rather, when a reporting entity has a greater obligation to absorb losses or right to receive benefits than its stated power, the reporting entity should approach the evaluation of the primary beneficiary with greater skepticism. This may require a reporting entity to consider whether it has clearly identified all elements of power with respect to the entity. When, after careful consideration of the disproportionality, a reporting entity concludes that it has appropriately determined which party has power, we believe that the reporting entity should clearly document its judgments with respect to its determination of power and its consideration of the disproportionality in power and benefits.

At the December 2009 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff expressed concerns with certain proposed structures in which a reporting entity may have asserted that power was shared, but the power and benefits were not proportional. In these circumstances, the staff also highlighted that ASC 810-10 indicates that only substantive terms, transactions and arrangements should be considered in arriving at a consolidation conclusion. When a reporting entity believes that power is shared but there is significant disproportionality between power and benefits, we believe that a reporting entity must consider carefully the entity’s purpose and design and whether the activities of the entity that most significantly impact economic performance have been appropriately identified. In doing so, only substantive terms, transactions and arrangements should be considered (see Chapter 3).

---

The SEC staff has also indicated that when a fee does not represent a variable interest and it is determined that the decision maker or service provider is acting as an agent it may be necessary to further consider whether the substance of the arrangement indicates that a party other than the decision maker or service provider is the party with power. In these cases, stated power may not be substantive, and it may be appropriate to attribute the agent's power to another variable interest holder if that variable interest holder absorbs all or essentially all of the VIE's variability.

**Illustration 8-11: Disproportionate power and benefits**

Assume the same facts as in Illustration 8-4, except that Reporting entity A holds 50% of the outstanding equity of Ice Cream Co. and Reporting entity B and Reporting entity C each hold 25%.

All profits and losses of Ice Cream Co. are allocated to the equity investors in proportion to their equity ownership. Each reporting entity can appoint one member to the board of directors. The board of directors hires a management team to carry out the day-to-day operations of the entity. All decisions related to Ice Cream Co.'s significant activities are taken to the board of directors and require the unanimous consent of all three directors.

**Analysis**

In this scenario, a reporting entity might conclude that power is shared and that Ice Cream Co. does not have a primary beneficiary because no single party has the power to direct the activities that most significantly impact the economic performance of the entity. However, a reporting entity should approach the evaluation of the primary beneficiary in this scenario with greater skepticism. Reporting entity A absorbs 50% of the economics in the VIE but has only 33.33% of the voting power, which may call into question whether all elements of power with respect to the entity have been identified.

**Question 8.9**

If a reporting entity concludes that an entity is a VIE pursuant to the “anti-abuse clause” (ASC 810-10-15-14(c)), does that conclusion affect the primary beneficiary determination?

To prevent an entity from avoiding consolidation of a VIE by structuring it with non-substantive voting rights, ASC 810-10-15-14(c) provides that an entity is a VIE when (1) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both and (2) substantially all of the entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights, including its related parties and certain de facto agents.

We do not believe that the holders of the equity interests of an entity that meet the criteria of ASC 810-10-15-14(c) should be presumed to have non-substantive voting rights. As such, determining the primary beneficiary of an entity that is a VIE pursuant to ASC 810-10-15-14(c) will require a careful examination of all facts and circumstances. In particular, the provisions of ASC 810-10-25-38G should be considered carefully. In addition, the provisions of ASC 810-10-15-13A and 15-13B that address substantive terms, transactions and arrangements should be evaluated.

Under FIN 46(R), the primary beneficiary of an entity that was a VIE as a result of ASC 810-10-15-14(c)’s provisions was often the party with disproportionately few voting rights, due to the previous Variable Interest Model’s quantitative approach for assessing which party was the primary beneficiary. Under FAS 167 and ASU 2015-02, the primary beneficiary of a VIE is the party that has (1) the power to direct activities of a VIE that most significantly impact the entity’s economic performance and (2) the obligation

---

to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE. Therefore, the party with disproportionately few voting rights may or may not be the primary beneficiary. However, when a reporting entity has a disproportionately greater obligation to absorb losses or right to receive benefits compared to its stated power, a reporting entity should approach the evaluation of the primary beneficiary with greater skepticism.

**8.4 Other frequently asked questions**

**Question 8.10 Can a VIE have more than one primary beneficiary?**

No. In paragraph 810-10-25-38A, the FASB acknowledges that multiple reporting entities may meet the benefits criterion but says that only one reporting entity can have the characteristic of power as defined in the Variable Interest Model. Thus, this characteristic would not result in a reporting entity identifying more than one party as the primary beneficiary. However, in some circumstances (e.g., shared power), a reporting entity may conclude that no one party has the power over a VIE.

Given that more than one reporting entity may evaluate a VIE for consolidation, it is possible that different reporting entities may make different judgments when identifying the primary beneficiary. The FASB has acknowledged that different conclusions from applying the Variable Interest Model among parties with interests in the same entity could result. However, as the FASB noted in paragraph A27 of the Basis for Conclusions to FAS 167, “the Board believes that if (a) the information used in the assessment is complete and accurate and (b) the analyses of the pertinent factors and characteristics of both the variable interests and the variable interest entity are performed using sound judgment, then the risk of inconsistency should be mitigated to an acceptable level.”

**Question 8.11 Can a VIE be the primary beneficiary of another VIE?**

Yes. If one VIE (the first VIE) holds a variable interest in another VIE (the second VIE), has the power over the second VIE and receives benefits from the second VIE, it should consolidate the second VIE as its primary beneficiary. In such cases, the primary beneficiary of the first VIE (if any) would include the consolidated financial statements of the first VIE (i.e., those financial statements consolidating the second VIE) in its consolidated financial statements.

Additionally, a VIE could be the primary beneficiary of a silo within a second VIE (see Chapter 6).

**Question 8.12 Does a reporting entity that determines that it would not be the primary beneficiary of an entity have to determine whether the entity is a VIE?**

The Variable Interest Model requires certain disclosures for a reporting entity that holds a variable interest in a VIE but is not the VIE’s primary beneficiary. Thus, the determination of whether an entity is a VIE is necessary for disclosure purposes. However, if the entity is not within the scope of the Variable Interest Model, no further analysis is required under the Variable Interest Model.

**Question 8.13 Does the Variable Interest Model affect the acquisition date provisions in ASC 805?**

ASC 805 provides that the acquisition date of a business combination is the date when the acquirer has the ability to control the operations of the target, which typically is the closing or consummation date. However, the acquisition date may be earlier if, among other conditions, the parties reach a firm purchase agreement and effective control of the target, including the risks and rewards of ownership, are transferred to the acquirer as of the designated date.
Generally, we do not believe that the provisions of the Variable Interest Model were designed to effectively amend or affect ASC 805’s acquisition date guidance. Accordingly, we believe that a firm agreement to acquire a business, by design, does not necessarily result in a change in control of the target unless the agreement provides the acquirer with power. The determination of whether a firm agreement provides the acquirer with power, which results in a business combination, should be made after considering all of the relevant facts and circumstances.
9 Determining the primary beneficiary in a related party group

9.1 Introduction

Excerpt from Accounting Standards Codification

Consolidation — Overall

Recognition — Variable Interest Entities

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 810-10-25-38A(b) (assuming it has no other relationships with the entity). Similarly, if an employee (or de facto agent) of the single decision maker owns an interest in the entity being evaluated and that employee’s (or de facto agent’s) interest has been financed by the single decision maker, the single decision maker would include that financing as its indirect interest in the evaluation. For example, if a 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.

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
In situations in which a single decision maker concludes, after performing the assessment in paragraph 810-10-25-42, that it does not have the characteristics in paragraph 810-10-25-38A, the single decision maker shall apply the guidance in paragraph 810-10-25-44 only when the single decision maker and one or more of its related parties are under common control and, as a group, the single decision maker and those related parties have the characteristics in paragraph 810-10-25-38A.

This paragraph applies to a related party group that has the characteristics in paragraph 810-10-25-38A only when both of the following criteria are met. This paragraph is not applicable for legal entities that meet the conditions in paragraphs 323-740-15-3 and 323-740-25-1.

a. The conditions in paragraph 810-10-25-44A are not met by a single decision maker and its related parties.

b. Substantially all of the activities of the VIE either involve or are conducted on behalf of a single variable interest holder (excluding the single decision maker) in the single decision maker’s related party group.

The single variable interest holder for which substantially all of the activities either involve or are conducted on its behalf would be the primary beneficiary. The evaluation in (b) above should be based on a qualitative assessment of all relevant facts and circumstances. In some cases, when performing that qualitative assessment, quantitative information may be considered. This assessment is consistent with the assessments in paragraphs 810-10-15-14(c)(2) and 810-10-15-17(d)(2).

A reporting entity first determines whether it individually has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance (power) and the obligation to absorb losses or the right to receive benefits of the VIE that potentially could be significant to the VIE (benefits).

A related party or de facto agent of the reporting entity could individually have power and benefits and be the primary beneficiary of a VIE. For purposes of the Variable Interest Model, the term “related parties” includes parties identified in ASC 850 and certain other parties that act as de facto agents of the variable interest holder as described in Chapter 10. However, if a reporting entity concludes that neither it nor one of its related parties individually meets the criteria to be the primary beneficiary, but that, as a group, the reporting entity and its related parties have those characteristics, the reporting entity considers the Variable Interest Model’s related party provisions to determine if one party in the group would be the primary beneficiary.

Under these provisions the reporting entity will have to analyze its related party group and determine whether there is a single decision maker or whether power is shared. In other words, a reporting entity will need to conclude whether a single variable interest holder has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance or whether power is shared among the related parties. This conclusion is important because the primary beneficiary guidance is different in those two circumstances.

9.2 Single decision maker (Updated February 2016)

We believe that a reporting entity would be considered a single decision maker if, individually, it has the ability through voting rights or similar rights to make the decisions about the activities that most significantly impact the entity’s economic performance. If a decision maker or service provider concludes that it does not have a variable interest in the entity, we believe that the decision maker or service provider is not required to evaluate the provisions of the Variable Interest Model further. This includes
determining whether the decision maker or service provider is the primary beneficiary of the entity and whether the decision maker or service provider is subject to the disclosure provisions of the Variable Interest Model (see Section 5.4.13).

Under the Variable Interest Model if a single decision maker has a variable interest in a related party that has a variable interest in the VIE, that interest is an indirect interest. Indirect interests are included after considering direct benefits solely. Additionally, a key factor in the evaluation is whether a reporting entity and its related parties with interests in the VIE are under common control.

The relationship between the single decision maker and the related party or de facto agent that holds the variable interest determines how the single decision maker considers the benefits:

- If the single decision maker and its related party or de facto agent are not under common control, the decision maker considers its *proportionate share* of the variable interest, herein referenced as indirect interest.
- If the single decision maker and its related party or de facto agents are under common control, the decision maker considers the entire indirect interest as its own. In other words, the decision maker will consider the benefits from its related party's or de facto agent variable interest equivalent to a direct interest.

In addition, if a decision maker finances a portion of an employee's or de facto agent's interest in a VIE, it will need to include its proportionate economic interest in the VIE. For example, if an employee of the decision maker holds a 20% equity investment in a VIE and the decision maker financed half of that investment, the decision maker’s indirect interest in the VIE will be 10%.

The following steps explain the application of the primary beneficiary guidance in situations when there is a single decision maker (refer to Chapter 1 for a comprehensive flowchart of how to apply the consolidation guidance):

**Step 1**
First, the single decision maker evaluates whether it individually has power and benefits. If it does, it consolidates the VIE. If it does not, the single decision maker analysis continues to Step 2.

**Step 2**
The single decision maker evaluates whether it has benefits, including its direct and indirect interests. This step excludes interests held in the VIE by a related party in which the single decision maker does not hold a direct interest. Indirect interests are considered in their entirety if the single decision maker and the related party are under common control or on a proportionate basis if they are not under common control. If the single decision maker has benefits, it will consolidate the VIE. If it does not, the single decision maker analysis continues to Step 3. See Section 2.7 for an update on recent standard setting activity associated with potential changes to the indirect interests considerations in the VIE model.

**Step 3**
The single decision maker evaluates whether its related parties, as a group, collectively, have power and benefits. This evaluation considers the entire related parties’ interests in the VIE even if the single decision maker does not hold a direct interest in the related parties that have an interest in the VIE. If the related parties, as a group, do not have power and benefits, the evaluation stops and no entity in the related party group will consolidate the VIE. If the related parties, as a group, have power and benefits, the single decision maker analysis continues to Step 4.
Step 4

If a single decision maker and its related parties are under common control, the party that is “most closely associated” with the VIE consolidates it as the primary beneficiary. Determining which party in a related party group is most closely associated with a VIE generally is a qualitative assessment and should be based on the facts and circumstances, and use of professional judgment is required (see Section 9.5). If the single decision maker and its related parties are not under common control, the single decision maker analysis continues to Step 5.

Step 5

The single decision maker will not consolidate the VIE. However, the reporting entity will determine whether “substantially all” the activities of the VIE are conducted on behalf of one of its related parties, based on a qualitative assessment of the facts and circumstances, similar to the consideration of the “anti-abuse” test required under ASC 810-10-15-14(c)(2) (see Section 7.4.2). If the reporting entity determines that “substantially all” the activities of the VIE are not conducted on behalf of one of its related parties, no party in the group would consolidate the VIE. If “substantially all” the activities of the VIE are conducted on behalf of one of its related parties, the related party on whose behalf substantially all of the activities of the VIE are conducted would consolidate the VIE.

Illustration 9-1: Primary beneficiary determination – single decision maker in a related party group with power and benefits

Entity A forms a limited partnership with a related party, Entity B. Entity A holds a 5% general partnership equity interest and makes all significant decisions for the partnership through its general partner interest. For providing services, Entity A also receives a fee that is commensurate with the services provided and includes only customary terms and conditions; the fee is significant in size. Entity B holds a 20% limited partnership equity interest and the remaining interests are dispersed among other investors. Entity A also has a 10% equity interest in Entity B. Assume the limited partnership is a VIE.

Analysis

(Note: The fee is not a variable interest because it is commensurate with the services provided, includes only customary terms and conditions and the other interests would not be significant after considering both direct and indirect interests (7% = 5% + 2%).

Entity A would have power through its equity interest. However it likely would conclude that its total equity interest of 7% (5% direct + 2% indirect (10% x 20%)) is not significant. Entity A’s related party group’s total equity interest of 25% (5% held by Entity A and 20% held by Entity B) would be considered significant. Because the entities are not under common control, Entity B would determine whether substantially all of the VIE’s significant activities are conducted on its behalf and if so, Entity B would consolidate the VIE. Entity A would not be the primary beneficiary and would not consolidate the VIE.
Illustration 9-2: Primary beneficiary determination – single decision maker under common control with indirect benefits through a related party

Assume the same facts as in Illustration 9-1, except Entity A and Entity B are under common control.

Analysis

The fee is a variable interest. We believe that the decision maker's total other interests for determining whether its fee is a variable interest would be 25% (i.e., 5% + 20%). The decision maker determines that the entire interest held by Entity B is included since Entity A has a direct interest in Entity B and Entity A and Entity B are under common control.

While Entity A would have power through its equity interest, it likely would conclude that its 5% equity interest does not absorb losses or receive benefits of the VIE that could potentially be significant to the VIE. Entity A would exclude its fee from the benefits analysis, because it is customary and commensurate. Entity A would be a single decision maker since it has unilateral power to direct the activities that most significantly impact the entity's economic performance. Additionally, its total equity interest of 25% (5% direct + 20% indirect) would be considered significant and Entity A would therefore be the primary beneficiary and consolidate the VIE. Entity A considers the entire indirect equity interest held by Entity B because the parties are under common control.

Illustration 9-3: Primary beneficiary determination – single decision maker under common control with no indirect benefits through a related party

Assume the same facts as in Illustration 9-1, except Entity A does not have a direct interest in Entity B, but Entity A and Entity B are under common control.

Analysis

The fee is not a variable interest. We believe that the decision maker's total other interests for determining whether its fee is a variable interest would be 5%. The interest held by Entity B is not included since Entity A does not have a direct interest in Entity B.
While Entity A would have power through its general partner interest, Entity A likely would conclude that its 5% equity interest does not absorb losses or receive benefits of the VIE that could potentially be significant to the VIE. Entity A would exclude its fee from the benefit analysis, because it is customary and commensurate. Entity A would have unilateral power to direct the activities that most significantly impact the entity’s economic performance because it makes all significant decisions for the VIE. The related party group’s total equity interest of 25% (5% held by Entity A and 20% held by Entity B) would be considered significant. As a result, the related party group would have power and benefits and Entity A or Entity B, whichever is most closely associated with the VIE, would be the primary beneficiary of the VIE and would consolidate it. Determining which party in a related party group is most closely associated with the VIE is a qualitative assessment and should be based on all relevant facts and circumstances (see Section 9.5).

### 9.3 Shared power among multiple related parties

In certain instances, power can be shared by a group of entities that are related parties. We believe this will happen when the consent of each of the related parties is required to make the decisions about the significant activities. If the related party group has shared power and benefits the parties are required to identify one entity as the primary beneficiary of the VIE. The member of the group that is “most closely associated” with the VIE (see Section 9.5) should consolidate it as the primary beneficiary.

#### Illustration 9-4: Shared power among multiple related parties

Three related parties, Entity A, Entity B and Entity C form an entity, Ice Cream Co., to manufacture, distribute and sell ice cream. Each entity obtained 33.33% of the equity of Ice Cream Co. (which is considered equity investment at risk) through equal contributions of cash upon formation of the entity. All profits and losses of Ice Cream Co. are allocated to the equity investors in proportion to their equity ownership. The entities hold no other variable interests in Ice Cream Co. besides their equity interests. There are no other variable interest holders in Ice Cream Co. Ice Cream Co. is determined to be a VIE.

Each entity can appoint one member to the board of directors. All decisions related to Ice Cream Co.’s significant activities are taken to the board of directors and require the unanimous consent of all three directors.

![Diagram](image)

#### Analysis

In this example, power is shared because the decisions about the activities that most significant impact the entity’s economic performance are made by the Board and require unanimous consent of all the related parties. In addition, the related party group has benefits through its at-risk equity investments in the VIE. Entity A, Entity B and Entity C, as a group, have power to direct the activities that most significantly impact the VIE’s economic performance and benefits. Therefore, one of the three entities, whichever is most closely associated with the VIE (see Section 9.5), would be the primary beneficiary of the VIE and would consolidate it.
9.4  Multiple decision makers within the related party group

A reporting entity evaluating consolidation of a VIE may conclude that there is not a single decision maker and power is not shared. Instead, there could be multiple parties, including parties in its related party group, that collectively have power over the activities that most significantly impact the VIE’s economic performance. We believe that in those situations a reporting entity needs to carefully evaluate the substance of the voting rights or similar rights as well as the purpose and design of the VIE to determine if any of the entities in its related party group should consolidate the VIE.

**Illustration 9-5:  Multiple decision makers in a related party group**

Three related parties, Entity A, Entity B and Entity C form an entity, Airplane Co., to manufacture and sell airplanes. Each related party obtained 25%, 30% and 45%, respectively, of the equity of Airplane Co. (which is considered equity investment at risk) through equal contributions of cash upon formation of the entity. All profits and losses of Airplane Co. are allocated to the equity investors in proportion to their equity ownership. The entities hold no other variable interests in Airplane Co. besides their equity interests. There are no other variable interest holders in Airplane Co. Airplane Co. is determined to be a VIE. All decisions related to Airplane Co.’s significant activities require simple majority vote of the equity holders’ voting interests.

Analysis

In this example, there is no single decision maker because none of the entities has the power to make the decisions about the activities that most significantly impact Airplane Co.’s economic performance (i.e., the voting rights held by each party represent less than simple majority). Power is not shared because consent of all the parties is not required to make the significant decisions. Therefore, we believe that in this situation no party has power and benefits (considering direct and indirect interests) and as a result no party consolidates Airplane Co.

**Illustration 9-6:  Multiple decision makers in a common control group**

Assume the same facts as in Example 9.5, except that Entity A and Entity B are wholly owned subsidiaries of Parent Co.
Analysis

As in Example 9.5, none of the entities has the power to make decisions about the activities that most significantly impact Airplane Co.’s economic performance. Power is not shared because consent of all the parties is not required to make the significant decisions. However, Parent Co. has a controlling financial interest in Entity A and Entity B. As a result, Parent Co. has the power to direct the decisions made by its common controlled subsidiaries. Although Parent Co. does not have a direct interest in the VIE, we believe it would have power and benefits when considering the purpose and design of the VIE as well as the substantive terms of the arrangement. In this example, we believe Parent Co. should consolidate Airplane Co.

9.5 Determining which party is most closely associated with a VIE

We believe determining which party in a related party group is most closely associated with a VIE is generally a qualitative assessment and should be based on all relevant facts and circumstances. While ASC 810-10-25-44 provides certain factors to consider in making this determination, these factors are not all-inclusive, and the use of professional judgment is required. We do not believe any one factor is determinative. The SEC staff has indicated that it shares this view.24

9.5.1 Principal-agency relationship

Generally, a principal-agency relationship exists if one member of a related party group (the agent) is acting on behalf of another member (the principal).

In some cases, it may be apparent that one member is a principal and another is an agent (e.g., when one member of the related party group is the employer of another or one member is the parent company of another). However, in other cases, the determination of whether one member is acting on behalf of another member may not be clear and should be based on an analysis of the specific facts and circumstances of the arrangement. The indicators of a principal or an agent described in ASC 605-45 may help reporting entities make this determination.

Based on ASC 605-45, we believe the following would be characteristics of a principal in a principal-agency relationship with other members of a group:

- The member can easily be identified by outside parties as the prime representative or leader of the related party group (i.e., as the one in charge).
- The member either directly or indirectly influenced other members to obtain a variable interest in the entity.

An agent, by contrast, generally would not possess these characteristics. Other characteristics also may exist and should be considered, if present.

While a principal-agency relationship is presumed to exist if a de facto agent is identified by applying the concepts in ASC 810-10-25-43 (see Chapter 10), we do not believe any one factor is determinative. The determination should be based on all relevant facts and circumstances.

---

24 See speech made by Jane D. Poulin at the 2004 AICPA National Conference on Current SEC and PCAOB Developments available at www.sec.gov. We believe that references to FIN 46(R) in the speech also would apply to the current Variable Interest Model.
9.5.2 Relationship and significance of a VIE’s activities to members of a related party group

The following factors should be considered when assessing the relationship and significance of a VIE’s activities to members of a related party group:

- Did any member significantly influence the design or redesign of the entity or the determination of its primary operations, products or services?
- Are the operations of any member substantially similar in nature to the activities of the VIE?
- Does the variable interest in the VIE represent a substantial portion of the total assets of any member?
- Are the products or services produced by the VIE significant inputs to any member’s operations?
- Has any member outsourced certain of its activities to the VIE?
- Are the majority of any member’s products or services sold to the VIE?
- Are the products or services of any member significant inputs to the VIE’s operations?
- Are employees of any member actively involved in managing the operations of the VIE?
- Do employees of the VIE receive compensation tied to the stock or operating results of any member?
- Is any member obligated to fund operating losses of the VIE if they occur?
- If the entity conducts research and development activities, does any member have the right to purchase any products or intangible assets resulting from the entity’s activities?
- Has a significant portion of the VIE’s assets been leased to or from any member?
- Does any member have a call option to purchase the interests of the other members?
- Do the other members have an option to put their interests to any member?

Illustration 9-7: Relationship and significance of a VIE’s activities to members of a related party group

An automobile manufacturer, Autoco, establishes a VIE, Safetyco, to research and develop enhanced safety technologies for automobiles. Autoco contributes technology with a fair value of $2 million to Safetyco in exchange for a 50% common equity interest. An auto parts supplier, Partco, invests $2 million in exchange for the remaining common equity interest. Autoco holds 25% of the common stock of Partco and accounts for this investment using the equity method, as specified by ASC 323. Safetyco obtains a $10 million loan from Autoco Credit, a majority-owned consolidated subsidiary of Autoco. Autoco, Autoco Credit and Partco are related parties under ASC 850.

Autoco has an option to acquire a five-year exclusive license for any enhanced safety technologies developed by Safetyco for use in the automobiles it manufactures. After five years, Partco also may license the technologies and sell products incorporating the technologies to other auto manufacturers.

The decisions about the activities that most significantly impact the VIE’s economic performance require unanimous consent from the three related parties.
### Analysis

In this example, power is shared among the related party group because the decisions about the activities that most significantly impact the VIE’s economic performance require unanimous consent from the parties. Because the related party group collectively has power and benefits the entity that is most closely associated with the VIE would be deemed its primary beneficiary.

We believe the relationship and significance of the VIE’s activities are more closely associated with Autoco. We considered the following facts in making this determination:

- Safetyco was formed to research and develop enhanced safety technologies for automobiles. Autoco is a manufacturer of automobiles.
- Autoco contributed the primary technology that Safetyco will try to further develop.
- Autoco has an option to acquire an exclusive license to any new technologies developed by Safetyco for an extended period of time.

The other factors in ASC 810-10-25-44 also should be considered in determining which party is the VIE’s primary beneficiary.

<table>
<thead>
<tr>
<th>9.5.3 Exposure to variability associated with the anticipated economic performance of the VIE</th>
</tr>
</thead>
<tbody>
<tr>
<td>In evaluating which party in a related party group is most closely associated with a VIE, a reporting entity should evaluate each party’s exposure to variability (both positive and negative) associated with the anticipated economic performance of the VIE. The party that absorbs a significantly greater portion of a VIE’s expected losses or receives a significantly greater portion of a VIE’s expected returns (compared with other parties in the related party group) may indicate that party is most closely associated with the VIE. While a detailed calculation of expected losses is not required, ASC 810-10-25-44 does require a consideration of a party’s exposure to variability associated with the anticipated economic performance of a VIE and, therefore, may require some quantitative analysis in its application.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>9.5.4 Purpose and design</th>
</tr>
</thead>
<tbody>
<tr>
<td>A member of a related party group should carefully consider the purpose and design of a VIE. For example, did any member significantly influence the design or redesign of the entity or the determination of its primary operations, products or services?</td>
</tr>
<tr>
<td>A member of a related party group should analyze the entity’s activities, including which parties participated significantly in the design or redesign of the entity, the terms of the contracts the entity entered into, the nature of interests issued and how the entity’s interests were marketed to potential investors. The entity’s governing documents, formation documents, marketing materials and all other contractual arrangements should be closely reviewed and combined with the analysis of the activities of the entity to determine which party is most closely associated with a VIE.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>9.6 One member of a related party group not clearly identified</th>
</tr>
</thead>
<tbody>
<tr>
<td>In certain situations, the factors provided in ASC 810-10-25-44 may identify multiple members of the related party group as a VIE’s primary beneficiary. In such cases, we believe that careful consideration of the individual facts and circumstances is necessary to determine which reporting entity is most closely associated to the VIE.</td>
</tr>
</tbody>
</table>
Illustration 9-8: One member of a related party group not clearly identified as primary beneficiary

Two parties (Party A and Party B) form a joint venture that is a VIE to manufacture, distribute and sell widgets. Both parties have 50% of the voting rights and represent 50% of the board of directors. Party A and Party B are related parties, and each requires the consent of the other party to make any decisions related to manufacturing, distributing and selling the widgets. Both parties, through their voting interests and board representation, jointly decide all other matters related to the VIE. Party A’s core business is to manufacture, distribute and sell widgets, while Party B’s core business is to manufacture, distribute and sell other products.

Analysis

Party A and Party B, together, share the power to direct the activities of the VIE that most significantly impact the entity’s economic performance. However, since Party A and Party B are related parties, they are required to identify one party as the primary beneficiary.

Both Party A and Party B were involved in the design of the VIE and are equally exposed to the expected losses and returns of the VIE. Also, since Party A and Party B are not related parties by virtue of a de facto agency relationship, a principal-agency relationship does not appear to exist between Party A and Party B. However, since Party A is in the business to manufacture, distribute and sell widgets while Party B’s core business is to manufacture, distribute and sell other products, the activities of the VIE are most closely related to Party A. Therefore, we believe Party A should consolidate the VIE because the activities of the VIE are most closely associated with Party A.

Question 9.1

How should a primary beneficiary account for equity interests in a VIE that are held by its related parties? In other words, should the primary beneficiary account for these interests as noncontrolling interests in its consolidated financial statements?

Yes. Unless the related parties also are consolidated by the primary beneficiary, equity interests in a VIE that are held by a primary beneficiary’s related parties should be accounted for as noncontrolling interests in the primary beneficiary's consolidated financial statements.
10 Related parties and de facto agents

10.1 Related parties

**Excerpt from Accounting Standards Codification**

**Related Party Disclosures — Overall**

**Glossary**

**850-10-20**

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

For purposes of the Variable Interest Model, the term “related parties” includes parties identified in ASC 850 and certain other parties that are acting as de facto agents of the variable interest holder unless otherwise specified. The Codification excerpt above defines “related parties” under US GAAP. A reporting entity should consider these related party relationships when evaluating the Variable Interest Model’s related party provisions (See Chapter 9).

10.2 De facto agents

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Recognition — Variable Interest Entities**

**810-10-25-43**

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

a. A party that cannot finance its operations without **subordinated financial support** from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary
b. A party that received its interests as a contribution or a loan from the reporting entity

c. An officer, employee, or member of the governing board of the reporting entity

d. A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party’s ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.

e. A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.

The Variable Interest Model also incorporates the concept of de facto agents into its consideration of related party relationships. De facto agents are considered along with related parties when evaluating the related party provisions unless otherwise specified. Given the broad definition of a de facto agent in the Variable Interest Model, reporting entities commonly determine that a de facto agency relationship exists.

Some of the de facto agency relationships in 810-10-25-43 are relatively straightforward. For example, parties are de facto agents of a reporting entity if they are financially dependent on the reporting entity (paragraph a), receive their investment or the funds to make their investment from the reporting entity (paragraph b) or are an officer, employee or member of the governing board of the reporting entity (paragraph c). The de facto agency relationships in paragraphs d and e require more judgment. These relationships are described further below.

We believe that the provisions of ASC 810-10-25-43 generally were intended to apply to equity interests. However, we believe these provisions also may apply to other variable interests, depending on the facts and circumstances.

10.2.1 **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**

Under the Variable Interest Model, a party that has an agreement that it cannot sell, transfer or encumber its interests in a VIE without the prior approval of a reporting entity is considered a de facto agent of that reporting entity if that right could constrain the party’s ability to manage the economics of its interest in a VIE. We believe the FASB intended this criterion to be all-inclusive, requiring that a party be restricted from selling, transferring and encumbering its interests for a de facto agency relationship to exist. If the party has the ability to obtain all or most of the cash inflows from its variable interest (i.e., realize the economic rewards) by selling, transferring or encumbering it, a de facto agency relationship does not exist. Otherwise, a party could construct a de facto agency relationship to achieve a desired accounting result simply by adding a prohibition that may be unimportant to that party. The legal agreements and, in particular, how those agreements define terms should be read carefully when evaluating whether all three of the restrictions exist. For example, we have observed instances in which it appears that only transfers of the interest are restricted, but the term “transfer” is defined in the legal agreement as any “sale, exchange, assignment, encumbrance, hypothecation, pledge, foreclosure, conveyance in trust, gift or other transfer of any kind,” among other actions. A reporting entity may need to consult with legal counsel when evaluating this criterion.
We believe all of the relevant facts and circumstances should be considered in determining whether restrictions on a party’s ability to sell, transfer and encumber its variable interest creates a de facto agency relationship. For example, a reporting entity may seek to avoid creating a de facto agency relationship with a party by restricting it only from selling or transferring its variable interest but not from encumbering it, knowing that the party is already restricted from encumbering its interest for a separate regulatory or legal reason. In this instance, we believe a de facto agency relationship exists because the reporting entity restricted the party from selling or transferring its interest and is aware that the party also is restricted from encumbering its interest.

Restrictions on the sale, transfer or encumbrance of a variable interest also should be carefully evaluated to ensure that they are substantive before concluding that a de facto agency relationship exists.

10.2.1.1 One-sided versus two-sided restrictions

A de facto agency relationship exists if the substantive sale, transfer and encumbrance restriction is one-sided (i.e., one party must approve the sale, transfer and encumbrance of another party’s interest but is not restricted itself). For example, assume a VIE’s variable interest holders consist of Investor A and Investor B. Investor A has an agreement with Investor B that prohibits Investor B from selling, transferring and encumbering its interest in the VIE without Investor A’s prior approval. However, Investor A is not restricted by Investor B from selling, transferring and encumbering its interest in the VIE. Since the restriction is one-sided, a de facto agency relationship exists.

A de facto agency relationship does not exist if both parties have an agreement that they cannot sell, transfer and encumber their interests in an entity without the prior approval of the other, and the rights are based on mutually agreed-upon terms entered into by willing, independent parties.

De facto agency relationships continue to arise in practice when substantive transfer restrictions are one-sided. The existence of a de facto agency relationship does not obviate the need for each party to determine whether it is the primary beneficiary of a VIE as described in Chapter 8. If a reporting entity concludes that neither it nor any of its related parties individually meets the criteria to be the primary beneficiary, but that, as a group, the reporting entity and its related parties or de facto agents have those characteristics, a reporting entity considers the Variable Interest Model’s related party provisions to determine if one party is the primary beneficiary as described in Chapter 9.

10.2.1.2 Common contractual terms

In evaluating whether a de facto agency relationship exists, questions often arise about the meaning of common contractual terms such as a right of first refusal, a right of first offer or an approval that cannot be unreasonably withheld.

10.2.1.2.1 Right of first refusal

A right of first refusal gives the holder of the right the ability to meet an offer before the transferring party can sell its interest to a third party. The right requires the transferring party to notify the holder of the right that it expects to sell its variable interest for a particular price and provides the holder of the right an option to purchase the transferring party’s interest at that price. If the party with the right of first refusal declines to enter into the transaction, the transferring party is free to sell its interest to other interested parties at the same price. Rights of first refusal are common in joint ventures and in the sale and leaseback of real estate. We believe that a right of first refusal generally does not create a de facto agency relationship because the transferring party is permitted to sell or transfer its interest. The right of first refusal gives the holder of the right the ability to meet an offer before an interest is sold or transferred to another party.
10.2.1.2.2 **Right of first offer**

A right of first offer requires the holder of the right to give notice to another party before selling its interest to a third party. That notice constitutes an offer by the party to sell its interest for the price, terms and conditions set forth in the notice. The potential buyer can decide either to accept or reject the terms of the offer. If the potential buyer does not accept the offer, it generally is deemed to have consented to the proposed sale, and the party may sell its interest to another party, as long as the price is not less than the price stated in the first offer and the terms are not any more favorable to the purchaser than the terms included in the first offer notice. The right of first offer may constrain the seller’s ability to sell its interest to a party of its own choosing. However, we believe that a right of first offer does not create a de facto agency relationship because the seller’s ability to sell its interest is not limited.

10.2.1.2.3 **Approval cannot be unreasonably withheld**

A party may have an agreement that it cannot sell, transfer or encumber its interests in an entity without the prior approval of a reporting entity and this approval cannot be unreasonably withheld. The issue is whether the clause “approval cannot be unreasonably withheld” affects the analysis of whether a de facto agency relationship exists. The Variable Interest Model does not distinguish an approval that is easier to obtain from one that is more difficult to obtain. Therefore, we believe the clause “approval cannot be unreasonably withheld” should be ignored in the analysis. That is, we believe that a party that has an agreement that it cannot sell, transfer and encumber its interests in a VIE without the prior approval of a reporting entity is considered a de facto agent of that reporting entity if that right could constrain the party’s ability to manage the economics of its interest in a VIE — even if the contractual arrangements explicitly state that a reporting entity cannot unreasonably withhold its approval.

10.2.2 A party that has a close business relationship

Determining whether a party that has a close business relationship with a reporting entity is acting as a de facto agent of that reporting entity depends on the specific facts and circumstances. We believe this provision was intended to identify relationships between a reporting entity and its investment bankers, attorneys and other professional service providers that help structure a transaction. We believe that the FASB’s objective was to prevent a reporting entity from avoiding consolidation of a VIE by protecting or indirectly expanding its interests through these professional service providers.

Close business relationships should be evaluated carefully to determine whether a reporting entity is a significant client of a professional service provider such that one of the parties may be prevented from fully pursuing its own separate interest.

10.2.3 Separate accounts of insurance enterprises as potential related parties

Pursuant to ASC 944-80-25-3, when evaluating whether it is required to consolidate an investment held by a separate account, an insurance enterprise should not:

- Consider any separate account interests held for the benefit of policyholders to be the insurance enterprise’s interests
- Combine any separate account interests held for the benefit of policyholders with the insurance enterprise’s general account interest in the same investment

However, separate account interests held for the benefit of a related party policyholder should be combined with the insurance enterprise’s general account interest when the Variable Interest Model requires the consideration of related parties. For this purpose, a related party policyholder includes any party identified in ASC 810-10-25-43 except:

- An employee of the insurance enterprise (and its other related parties), unless the employee is used in an effort to circumvent the provisions of the Variable Interest Model
- An employee benefit plan of the insurance enterprise (and its other related parties), unless the employee benefit plan is used in an effort to circumvent the provisions of the Variable Interest Model
11 Reconsideration events

11.1 Reconsideration of whether an entity is a VIE

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidation – Overall</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Subsequent Measurement – Variable Interest Entities</strong></td>
<td></td>
</tr>
<tr>
<td>810-10-35-4</td>
<td></td>
</tr>
<tr>
<td>A legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its expected losses that reduce the equity investment. The initial determination of whether a legal entity is a VIE shall be reconsidered if any of the following occur:</td>
<td></td>
</tr>
<tr>
<td>a. The legal entity’s governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity’s equity investment at risk.</td>
<td></td>
</tr>
<tr>
<td>b. The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity.</td>
<td></td>
</tr>
<tr>
<td>c. The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity’s expected losses.</td>
<td></td>
</tr>
<tr>
<td>d. The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses.</td>
<td></td>
</tr>
<tr>
<td>e. Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity’s economic performance.</td>
<td></td>
</tr>
</tbody>
</table>

The Variable Interest Model requires a reporting entity to reevaluate whether an entity is a VIE upon the occurrence of certain significant events, such as those listed in ASC 810-10-35-4, and not at each reporting date. An event is significant if it changes the design of the entity and calls into question whether (1) the entity’s equity investment at risk is sufficient or (2) the holders of the entity’s equity investment at risk, as a group, have the characteristics of a controlling financial interest. Presumably, an entity’s variable interest holders should be aware of these types of events.

The requirement to reassess whether an entity is a VIE, and the possibility that an entity could move in and out of VIE status, could create accounting and reporting challenges for some reporting entities. A reporting entity is required to understand whether any events requiring a reassessment could occur and, if so, to monitor the activities of entities in which it holds variable interests. A reporting entity also must establish internal control procedures to identify significant events on a timely basis. This may require a reporting entity to establish procedures to receive information routinely from entities in which it holds variable interests even if it is not the primary beneficiary of the entity or the entity is not currently a VIE.

When a reconsideration event occurs, we believe a reporting entity must reevaluate the risks the entity is designed to create and distribute to its interest holders, as described in Section 5.2.1.2. Careful consideration of the facts and circumstances for each entity is necessary to determine whether there has been a change in the purpose and/or design of the entity.
11.1.1 Common VIE reconsideration events

Common events that require reconsideration of whether an entity is a VIE include the following when, by design, they change the structure of the entity (this list is not all-inclusive, and the determination of whether an event requires reconsideration of the entity's status as a VIE requires professional judgment):

- Additional contributions by existing equity investors
- Issuances of additional equity interests
- Returns of equity to investors (i.e., distributions in excess of earnings)
- Revisions to equity holders’ voting rights
- Entry into a significant new line of business that increases the entity's expected losses
- Purchases of guarantees or put options
- Significant curtailment of the entity’s existing activities through sale of assets or discontinuance of a line of business
- Troubled debt restructuring
- Lapse of certain rights such as participating or substantive kick-out rights (e.g., a lapse in participating rights held by one party to determine the operating budget of a VIE after the first two years of a VIE’s existence)
- Debt refinancings
- Retirement of debt at other than its contractual maturity date
- Entry into agreements with service providers
- Revisions to significant service contracts
- Leases of significant new assets
- Revisions to existing lease terms, including those that result in a new lease pursuant to ASC 840
- Significant acquisitions of new assets
- Bankruptcy or liquidation
- Acquisition or sale of interests that constitute a change of control
- Termination of contractual arrangements that conveyed power

Any of these events may trigger a need to reconsider whether an entity is a VIE if the event represents a substantive change in the design of the entity and calls into question whether (1) the entity's equity investment at risk is sufficient or (2) the holders of the entity's equity investment at risk, as a group, have the characteristics of a controlling financial interest.

As described in Chapter 3, only substantive terms, transactions and arrangements should be considered when applying the Variable Interest Model. Any term, transaction or arrangement is disregarded if it does not have a substantive effect on (1) an entity's status as a VIE, (2) a reporting entity's power over a VIE or (3) a reporting entity's obligation to absorb losses or its right to receive benefits of the entity. Therefore, a reporting entity should determine whether an event is substantive such that it requires reconsideration of an entity's status as a VIE. Non-substantive changes or events do not trigger reconsideration. Determining whether an event is substantive requires the use of judgment.
### Illustration 11-1: Determining whether a reconsideration event is substantive

#### Example 1

A leasing company, Leaseco, is formed as an LLC and acquires four commercial office buildings for a total of $400 million. The acquisition is financed with $100 million of equity contributions from Leaseco’s equity investors and $300 million of senior, secured debt. The buildings are leased to multiple unrelated parties under operating leases based on market terms at the inception of the leases. None of the leases contain residual value guarantees, purchase options or similar features. Leaseco is determined to be a voting interest entity at its inception.

During the third year of its existence, because of an increase in the fair value of a building, Leaseco refinances its debt. The proceeds are distributed to the equity owners of Leaseco.

**Analysis**

We believe the refinancing is a substantive event requiring reconsideration of whether Leaseco is a VIE because it changes the contractual arrangements among the parties and could affect whether the entity’s equity investment at risk is sufficient. The distribution to equity investors also may represent a reconsideration event (see Section 11.1.1.4).

#### Example 2

After four years, a lease is modified to extend its term from its original 10-year period to a 12-year period. Periodic rental payments due and other significant terms of the lease remain unchanged.

**Analysis**

The extension of the lease period results in a new lease under ASC 840. Accordingly, the variable interest holders should reconsider whether Leaseco is a VIE.

#### Example 3

During its fifth year of existence, Leaseco purchases another building and leases it to an unrelated third party. The acquisition of the building significantly increases Leaseco’s expected losses.

**Analysis**

We believe the purchase of the additional building is a substantive event requiring reconsideration of whether Leaseco is a VIE because the acquisition has significantly increased the entity’s expected losses and could affect whether Leaseco’s equity investment at risk is sufficient to absorb those losses.

#### Example 4

After six years, the governing documents of Leaseco are modified to change the way equity investors can cast their votes. Equity investors are no longer required to be present in person to cast a vote at a board meeting. Instead, they can do so via a conference call.

**Analysis**

Although this is a contractual change, it is not a substantive change to the design of the entity. Accordingly, there is no need to reconsider whether the entity is a VIE.

#### Example 5

After 10 years, the equity holders agree to restructure Leaseco into a limited partnership. In connection with the restructuring, the partnership refinances the debt and issues additional equity to new investors.

**Analysis**

The restructuring of the entity is a substantive change in the design of the entity. Accordingly, the variable interest holders should reconsider whether Leaseco is a VIE.
11.1.1 Conversions of accounts receivables into notes

Vendors may, from time to time, convert past-due trade accounts receivable from a customer into an interest-bearing note receivable. We believe that a substantial conversion may constitute a reconsideration event if the entity's contractual arrangements are changed in a manner that calls into question whether the entity's equity investment at risk is sufficient. Because a troubled debt restructuring could constitute a reconsideration event, we believe that the conversion of past-due trade accounts receivable could be an event requiring reconsideration of whether an entity is a VIE.

11.1.1.2 Transfer of an entity's debt between lenders

We believe the transfer of an entity's debt between lenders would not result in a change in the design of the underlying entity. That is, the transfer generally does not call into question the sufficiency of the entity's equity investment at risk or the rights and obligations of the entity's at-risk equity holders.

Based on discussions with the FASB staff, we believe the acquirer of an entity's debt should consider the original design of the entity or its design at the last reconsideration event (whichever is later) to determine whether the entity is a VIE. If the entity was not a VIE upon its creation, or at the latest reconsideration date (if there was one), the acquirer of the debt would follow other GAAP to account for its investment.

11.1.1.3 Asset acquisitions and dispositions

We believe that asset acquisitions and dispositions require reconsideration if they are significant. Such events are significant only if they change the design of an entity in a manner that calls into question whether (1) the entity's equity investment at risk is sufficient or (2) the holders of the entity's equity investment at risk, as a group, have the characteristics of a controlling financial interest. For example, an entity that acquires office furniture for a headquarters facility may have acquired assets that are, in the aggregate, material to its balance sheet, but those assets generally would not significantly increase the entity's expected losses. Accordingly, no reconsideration event has occurred. In contrast, an entity that acquires an asset that significantly increases its expected losses would be subject to reconsideration as a potential VIE.

Illustration 11-2: Asset acquisitions and dispositions as reconsideration events

Example 1

A leasing company, Leaseco, is formed as an LLC and acquires two commercial office buildings for $200 million. The acquisition is financed with $100 million of equity contributions from Leaseco's equity investors and $100 million of senior, secured debt. At the end of five years, Leaseco borrows $100 million from an unrelated lender and uses the proceeds to acquire an additional office building. The purchase of the third office building significantly increases Leaseco's expected losses.

Analysis

At the end of the fifth year, the variable interest holders in Leaseco should reconsider whether Leaseco is a VIE because the acquisition of the additional office building has significantly increased the entity's expected losses and could affect whether Leaseco's equity investment at risk is sufficient to absorb those losses.

However, if the $100 million borrowing and related asset meet the characteristics of a silo (see Chapter 6), Leaseco's variable interest holders would not be required to reconsider whether the entity is a VIE. This is because expected losses related to silos are not considered expected losses of the larger host entity. Therefore, while the acquisition of the additional office building would be significant, it would not increase the expected losses absorbed by Leasco's at-risk equity holders.
Example 2
During year eight, Leaseco sells two of its three buildings at a substantial gain. The proceeds from the sales are distributed in their entirety to Leaseco's equity investors in accordance with the contractual arrangements among the investors.

Analysis
The variable interest holders in Leaseco should reconsider whether Leaseco is a VIE because the sale of the buildings is a significant curtailment of the entity's activities that has decreased the entity's expected losses and could affect whether the entity's equity investment at risk is sufficient to absorb those losses. The distribution to equity investors also may represent a reconsideration event (see Section 11.1.1.4).

11.1.1.4 Distributions to equity holders
We believe returns on equity may be distributed without triggering a need to reconsider whether an entity is a VIE. We believe a reconsideration event occurs only when a return of equity exceeds earnings and exposes other variable interest holders to expected losses, thus calling into question whether the entity's remaining equity investment at risk is sufficient.

Illustration 11-3: Distributions to equity holders as reconsideration events

Example 1
A leasing company, Leaseco, is formed as an LLC and acquires commercial office buildings that are leased to multiple unrelated parties under operating leases based on market terms at inception of the leases. The office buildings are financed with equity contributions from Leaseco's equity investors and borrowings from an unrelated lender. At the end of five years, Leaseco begins to pay its members dividends that amount to 80% of its annual net income.

Analysis
These dividends represent returns on equity to Leaseco’s members. Accordingly, we believe the distributions would not trigger a reconsideration of whether Leaseco is a VIE.

Example 2
At the end of eight years, Leaseco refinances its debt because of appreciation in the building's fair value and distributes an amount that exceeds its earnings to the LLC members.

Analysis
A reconsideration event has occurred because the distribution exceeds the entity’s return on equity, and the lender is now exposed to greater expected losses. The refinancing also is a substantive event requiring reconsideration of whether Leaseco is a VIE because it changes the contractual arrangements among the parties involved in the entity.


11.1.5 Replacement of temporary financing with permanent financing

Many entities use temporary financing when constructing assets and obtain permanent financing when construction is complete. This kind of change in financing generally requires reconsideration of whether the entity is a VIE. The permanent financing represents a change in the contractual agreements among the parties involved in the entity and could change the determination of whether (1) the entity’s equity investment at risk is sufficient or (2) the holders of the entity’s equity investment at risk, as a group, have the characteristics of a controlling financial interest.

However, if the lender that provides the construction financing also provides the permanent financing, and all significant terms of the permanent financing (e.g., amount, interest rate, covenants, maturity date) are contractually agreed to at the commencement of construction, we believe the rollover to permanent financing would not require reconsideration. Instead, the terms of the contractual arrangements and the rollover of the construction financing to permanent financing should be considered in the initial determination of whether the entity is a VIE and which party, if any, is the primary beneficiary.

Illustration 11-4: Refinancings as reconsideration events

An entity is formed with a temporary construction loan of $900 and equity of $100. At formation, the entity is determined to be a VIE. The proceeds from the debt and equity issuances are used to build a hotel. At the end of the construction phase, the hotel’s fair value is $3,000. At that time, the VIE obtains permanent financing for 80% of the hotel’s value ($2,400) and uses the proceeds to repay the construction loan of $900 and make a distribution to the equity holders of $1,000.

The replacement of the temporary financing with permanent financing (including the significant distribution to equity holders) is a substantive change in the contractual arrangements among the parties and could affect the determination of whether the entity is a VIE. Therefore, the variable interest holders should reconsider whether the entity is a VIE.

11.1.6 Adoption of accounting standards

We do not believe the adoption of a new accounting standard is an event that requires a reporting entity to reconsider whether an entity is a VIE unless the new standard specifically requires reconsideration.

11.1.7 Incurrence of losses that reduce the equity investment at risk

An entity that previously was not subject to the Variable Interest Model does not become subject to it simply because of losses that reduce its equity investment, even if those losses exceed expected losses or the equity investment is reduced to zero. In other words, if the amount of the equity investment at risk at the entity’s inception was determined to be sufficient, the incurrence of losses, by themselves, would not trigger a need to reconsider whether the entity continues to have sufficient equity.

However, if a voting interest entity experiences severe losses that call into question whether the holders of the entity’s equity investment at risk, as a group, have the characteristics of a controlling financial interest, a reporting entity should reconsider whether the entity is a VIE. For example, a voting interest entity may experience such severe losses that another party (e.g., a guarantor or lender) obtains a controlling financial interest in the entity.

11.1.8 Acquisition of a business that has a variable interest in an entity

We do not believe the acquisition of a business that has a variable interest in an entity triggers the need to reconsider whether that entity is a VIE unless the acquisition represents a substantive change in the design of the entity that calls into question whether (1) the entity’s equity investment at risk is sufficient or (2) the holders of the entity’s equity investment at risk, as a group, have the characteristics of a controlling financial interest.
We generally believe that the acquisition of a business represents a transfer of variable interests between holders that generally does not result in a change in the design of the underlying entity. That is, the transfer generally does not call into question the sufficiency of the entity’s equity investment at risk or the rights and obligations of the entity’s at-risk equity holders. However, assume the acquirer also holds a variable interest in the entity and previously applied the business scope exception to that entity (see Section 4.4.4). Upon acquisition of a business that holds a variable interest in that entity, the acquirer should reconsider whether the business scope exception continues to apply.

11.1.1.9 Bankruptcy

We believe that when an entity files for bankruptcy, a reporting entity should reconsider whether the entity is a VIE. Generally, when an entity files for bankruptcy, the equity holders, as a group, would no longer have the characteristics of a controlling financial interest. Entities that file for bankruptcy in the US are typically under the control of the bankruptcy court. Therefore, if a reporting entity currently consolidates an entity under the Voting Model or Variable Interest Model and that entity subsequently files for bankruptcy, the reporting entity likely will deconsolidate the entity because it will no longer have the power to direct the activities that most significantly impact the entity's economic performance. Local laws and regulations should be considered for entities that file for bankruptcy in a foreign jurisdiction. See Section 3.9.13 of our FRD, Bankruptcies, liquidations and quasi-reorganizations, for additional guidance.

11.1.1.10 Loss of power or similar rights

The Variable Interest Model requires a reporting entity to reevaluate whether an entity is a VIE when certain significant events occur that call into question whether the holders of the entity’s equity investment at risk, as a group, have the characteristics of a controlling financial interest. Although event-driven, a loss of power or similar rights also could occur through an agreement that prescribes when another party obtains power. For example, a loan agreement may state that the lender obtains certain rights to manage the activities of the borrower if the collateral’s fair value falls below the loan’s outstanding principal balance. When such an event occurs, if the lender is deemed to have obtained power to direct the activities of the borrower that most significantly impact the borrower's economic performance, the equity holders would no longer have power. However, if the loan agreement gives the lender the right to foreclose on the borrower in the event of default, the equity holders may not lose power or similar rights until the lender exercises its rights to foreclose and actually takes control.

Question 11.1 If a reconsideration event occurs, should the sufficiency of an entity’s equity investment at risk be measured based on the carrying amount of the entity’s equity, as reported in its GAAP balance sheet, or the fair value of the equity interests?

We believe the fair value (as defined by ASC 820) of the equity investment at risk as of the date the evaluation is performed should be used to evaluate the sufficiency of the equity investment at risk.

Question 11.2 What are some SEC reporting considerations following the consolidation or deconsolidation of a VIE upon a reconsideration event?

An SEC registrant must consider whether it has any SEC reporting requirements following the consolidation or deconsolidation of a VIE upon a reconsideration event. The SEC staff discussed this point at the SEC Regulations Committee on 22 September 2009 and March 31, 2015 (see Section 12.6.2).
11.2 Reconsideration of whether a reporting entity is the primary beneficiary

The Variable Interest Model requires a reporting entity to continuously assess whether it is the primary beneficiary of a VIE. This assessment should not occur only at the end of each reporting period. Instead, it should occur when circumstances warrant a change in a reporting entity's status as the primary beneficiary. The continuous assessment of a primary beneficiary is consistent with the application of ASC 810-10 to voting interest entities, which implicitly requires continuous consideration of whether consolidation is required.

The primary beneficiary changes when there is a change in a reporting entity's power or benefits (see Chapter 8). In practice, we believe that these changes are evident to a reporting entity that ceases to be the primary beneficiary because it lost power or becomes the primary beneficiary because it obtained power. Reporting entities may need to establish processes to track changes in power, changes in variable interests or changes to de facto agent and related party relationships.

Some examples of circumstances that may cause a change in the primary beneficiary include, but are not limited to:

- Acquisition or sale of interests that constitute a change of control
- Lapse of certain rights such as participating or substantive kick-out rights (e.g., a lapse in participating rights held by one party to determine the operating budget of a VIE after the first two years of a VIE's existence)
- Termination of contractual arrangements that conveyed power
12 Initial measurement and consolidation

12.1 Introduction

Paragraphs 810-10-30-1 through 30-4 provide guidance on how a primary beneficiary should initially consolidate a VIE. The primary beneficiary’s initial measurement and consolidation differs depending on whether the primary beneficiary and the VIE are under common control or whether the VIE is a business.

12.2 Primary beneficiary and VIE are under common control

Excerpt from Accounting Standards Codification

<table>
<thead>
<tr>
<th>Consolidation — Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Measurement — Variable Interest Entities</td>
</tr>
<tr>
<td>810-10-30-1</td>
</tr>
<tr>
<td>If the primary beneficiary of a variable interest entity (VIE) and the VIE are under common control, the primary beneficiary shall initially measure the assets, liabilities, and noncontrolling interests of the VIE at amounts at which they are carried in the accounts of the reporting entity that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles [GAAP]).</td>
</tr>
</tbody>
</table>

When there is a change in a VIE’s primary beneficiary between entities that are under common control, the new primary beneficiary should initially measure the assets, liabilities and noncontrolling interests of the VIE at the amounts at which they were carried in the accounts of the reporting entity that formerly controlled the VIE (i.e., carryover basis should be used with no adjustment to current fair values, and no gain or loss should be recognized). Also, because transactions among entities under common control do not result in a change in control at the ultimate parent level, the ultimate parent’s consolidated financial statements will not be affected by a common control transaction. This accounting is similar to the accounting applied to transactions between entities under common control described in ASC 805-50-30-5 (See Appendix C of our FRD, Business combinations).

12.3 Primary beneficiary of a VIE that is a business

Excerpt from Accounting Standards Codification

<table>
<thead>
<tr>
<th>Consolidation — Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Measurement — Variable Interest Entities</td>
</tr>
<tr>
<td>810-10-30-2</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

The primary beneficiary of a VIE that is a business is required to measure the assets, liabilities and noncontrolling interests of the newly consolidated entity in accordance with ASC 805 at the date the reporting entity first becomes the primary beneficiary. Any goodwill recognized in the initial consolidation of a VIE should be evaluated for impairment pursuant to the provisions of ASC 350.

See our FRD, Business combinations, for additional discussion of the provisions of ASC 805.
12.4 Primary beneficiary of a VIE that is not a business

**Excerpt from Accounting Standards Codification**

**Business Combinations – Related Issues**

**Scope and Scope Exceptions**

805-50-15-4

The guidance in the Acquisition of Assets Rather than a Business Subsections does not apply to the initial measurement and recognition by a primary beneficiary of the assets and liabilities of a variable interest entity (VIE) when the VIE does not constitute a business. Guidance for such a VIE is provided in Section 810-10-30.

Pursuant to ASC 805-50-15-4, a primary beneficiary’s initial measurement and recognition of the assets and liabilities of a VIE that does not constitute a business is excluded from the scope of ASC 805-50 for asset acquisitions. Accordingly, a primary beneficiary of a VIE that does not constitute a business applies the guidance in ASC 810-10-30 for initial measurement and recognition of the assets acquired and liabilities assumed upon initial consolidation.

**Consolidation – Overall**

**Initial Measurement – Variable Interest Entities**

810-10-30-3

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.

810-10-30-4

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.

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 805-20-30 and no goodwill should be recognized. These provisions generally provide that the primary beneficiary should recognize 100% of the identifiable assets acquired (except goodwill), the liabilities assumed and any noncontrolling interests, at fair value (see Chapters 3 and 4 of our FRD, *Business combinations*).
However, when a reporting entity 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, the primary beneficiary should initially 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 (except goodwill), liabilities and noncontrolling interests should be measured in accordance with the provisions of ASC 805-20-25 and 805-20-30. The objective of this provision is to prevent the improper recognition of gains or losses due to the transfer of assets and liabilities to a VIE by its primary beneficiary.

If a reporting entity transfers assets and liabilities to a VIE shortly after becoming its primary beneficiary, the transaction would represent a transaction among entities under common control (i.e., a transaction between a parent and subsidiary). Thus, the transaction should be accounted for consistently with transactions falling under the common control provisions of ASC 805-50-30-5. With respect to transfers of assets and liabilities occurring shortly before a reporting entity becomes a VIE’s primary beneficiary, it may be unclear whether the transaction is a separate economic exchange or is in contemplation of the change in control. As a result, the Variable Interest Model requires that when a reporting entity transfers assets and liabilities to a VIE that is not a business shortly before becoming the VIE’s primary beneficiary that the transaction be treated as a common control transaction. A reporting entity will be required to exercise professional judgment in determining what would qualify as “shortly before.”

### 12.4.1 Contingent consideration in an asset acquisition when the entity is a VIE that does not constitute a business

If a reporting entity uses contingent consideration in a transaction in which it becomes the primary beneficiary of a VIE that does not constitute a business, it must recognize the contingent consideration arrangement at its acquisition date fair value as part of the consideration transferred, in accordance with the guidance in ASC 805-30-25-5 through ASC 805-30-25-7.

### Question 12.1

If a reporting entity is the primary beneficiary of a VIE, would it be appropriate to issue combined financial statements rather than consolidated financial statements?

No. ASC 810-10-55-1B permits combined financial statements in certain situations in which consolidated financial statements are not required. However, a primary beneficiary of a VIE must consolidate the VIE.

### 12.5 Primary beneficiary of a VIE that is a collateralized financing entity

**Excerpt from Accounting Standards Codification**

**Consolidation – Overall**

**Glossary**

**810-10-20**

**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).
In August 2014, the FASB issued ASU 2014-13 to eliminate the measurement difference that sometimes arises when a collateralized financing entity’s (CFE’s) financial assets and financial liabilities are independently measured at fair value, as required by ASC 820. The ASU defines a CFE and provides a measurement alternative to ASC 820 for reporting entities that consolidate qualifying CFEs. Under the alternative, the entity may elect to measure both the CFE’s financial assets and financial liabilities using the fair value of either the CFE’s financial assets or financial liabilities, whichever is more observable.

The guidance also clarifies that a reporting entity that does not elect the alternative will reflect any difference between the fair values of a consolidated CFE’s financial assets and financial liabilities in earnings and will attribute these differences to the reporting entity (i.e., controlling interest holder) in the consolidated statement of income (loss). See Appendix E for further guidance and transition and effective date.

12.6 Other considerations

12.6.1 Pro forma and Form 8-K reporting requirements

Article 11 of SEC Regulation S-X (Article 11) describes the SEC’s requirements for registrants to provide pro forma financial information. Article 11 applies to registration statements, certain proxy statements and Form 8-K filings. Item 2.01 of Form 8-K describes the reporting requirements relating to a registrant’s acquisition or disposition of a significant amount of assets.

With regard to the consolidation or deconsolidation of a VIE, the SEC staff indicated that the initial adoption of ASU 2015-02 would not trigger a requirement to report under Article 11 or Item 2.01 of Form 8-K or the need for pro forma financial information under Article 11. However, for the ongoing application of the Variable Interest Model, the SEC staff believes that a registrant would be required to consider the requirements under Article 11 and Item 2.01 of Form 8-K.

12.6.2 SEC Regulation S-X Rules 3-05 and 3-14 and Form 8-K reporting requirements

Rule 3-05 of SEC Regulation S-X (Rule 3-05) describes the SEC’s requirements for registrants to provide audited financial statements of a business acquired or to be acquired, including the acquisition of an interest in a business accounted for under the equity method if there is significant acquisition that is required to be reported on a Form 8-K under Item 2.01. Rule 3-14 of SEC Regulation S-X (Rule 3-14) describes the requirements for audited financial statements of real estate operations acquired or to be acquired.

When FAS 167 was issued, the SEC staff indicated that consolidation upon the initial adoption of FAS 167 would not trigger a requirement to file financial statements under Rule 3-05 or Rule 3-14. However, the SEC staff stated that after an entity’s adoption of FAS 167, a registrant would be required to consider the requirements of Rule 3-05 and Rule 3-14 when becoming the primary beneficiary of a VIE; that is, the registrant would need to determine whether the resulting consolidation triggered a reporting requirement under Item 2.01 of Form 8-K and the need for separate financial statements under Rules 3-05 or 3-14.

We believe the SEC staff’s views with respect to the application of Rule 3-05 and Rule 3-14 upon adoption of ASU 2015-02 would be consistent with their prior views with respect to FAS 167. That is, we believe that consolidation upon the initial adoption of ASU 2015-02 would not trigger a requirement to report under Rule 3-05 or Rule 3-14. However, we believe that after a registrant adopts ASU 2015-02, it would be required to consider the Item 2.01 requirements and Rule 3-05 and Rule 3-14 for the ongoing application of the Variable Interest Model (that is, initial consolidation of a VIE).

25 The SEC staff shared this view with the Center for Audit Quality SEC Regulations Committee on March 31, 2015.
26 The SEC staff shared this view with the Center for Audit Quality SEC Regulations Committee (CAQ Alert #2010-20 – April 9, 2010).
12.7 Pre-existing hedge relationships under ASC 815

When a reporting entity is required to consolidate or deconsolidate an entity pursuant to ASC 810-10, it must discontinue a pre-existing hedging relationship (between the reporting entity and the newly consolidated entity or relating to assets no longer consolidated) that qualified as an accounting hedge under ASC 815 in its financial statements. Questions sometimes arise about what adjustments, if any, should be made in the reporting entity’s financial statements with respect to the previous hedge accounting.

This issue originally was addressed by FAS 133 Implementation Issue No. E22. Note that Issue E22 is not included in the Codification because it related specifically to the initial adoption of FIN 46(R). The FASB elected not to include this transition guidance in the Codification.

The guidance in Issue E22 applied to the adjustments made to the previous hedge accounting for a pre-existing hedging relationship that was discontinued because of consolidation or deconsolidation of another entity due to the initial application of FIN 46 or FIN 46(R). Although this guidance was intended to apply only to the “initial application” of FIN 46 or FIN 46(R), we believe that subsequent consolidation or deconsolidation required pursuant to FAS 167 or ASU 2015-02 (including upon adoption of after adoption) should not result in the immediate recognition of previously deferred derivative gains and losses if a surrogate hedge item can be identified. Issue E22 states that the guidance in the Issue “should also be applied by analogy to situations in which the issuance of new authoritative guidance results in a reporting entity becoming a primary beneficiary under Interpretation 46(R) and, therefore, must consolidate the related VIE.” ASU 2015-02 and FAS 167 amended FIN 46(R)’s variable interest model. Therefore, we believe that Issue E22 provides for an explicit analogy to its guidance upon adoption of ASU 2015-02 or FAS 167 or after adoption of those standards.

12.8 Continuation of leveraged lease accounting by an equity investor in a deconsolidated lessor trust

Based on our discussions with the FASB staff, we understand that the deconsolidation of a previously consolidated lessor trust by an equity investor through application of the Variable Interest Model should not change the equity investor’s accounting for the lease between the lessor trust and the lessee. That is, if the equity investor appropriately applied leveraged lease accounting pursuant to ASC 840 before deconsolidation, that accounting treatment should continue to be followed.
13 Presentation and disclosures

13.1 Presentation

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidation – Overall</strong></td>
</tr>
<tr>
<td><strong>Other Presentation Matters – Variable Interest Entities</strong></td>
</tr>
<tr>
<td><strong>810-10-45-25</strong></td>
</tr>
<tr>
<td>A reporting entity shall present each of the following separately on the face of the statement of financial position:</td>
</tr>
<tr>
<td>a. Assets of a consolidated variable interest entity (VIE) that can be used only to settle obligations of the consolidated VIE</td>
</tr>
<tr>
<td>b. Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.</td>
</tr>
</tbody>
</table>

The Variable Interest Model requires a reporting entity to present certain assets and liabilities of a consolidated VIE separately on the face of its balance sheet. In arriving at that conclusion, the FASB considered but rejected a single line-item display of assets and liabilities or net assets and liabilities of VIEs. In other words, qualifying assets and liabilities of VIEs should be presented separately on the balance sheet for each major class of assets and liabilities (e.g., cash, accounts receivable, property, plant and equipment). Although noncontrolling interests are not subject to separate presentation requirements, we believe a reporting entity is permitted to present noncontrolling interests separately as long as it makes an accounting policy choice and applies that choice to all consolidated VIEs.

The Variable Interest Model does not provide examples of or detailed implementation guidance on how reporting entities may satisfy the separate presentation requirements. We believe that reporting entities should carefully consider the separate presentation requirements and ensure that adequate financial reporting systems are established to track and capture the assets and liabilities of consolidated VIEs that meet the criteria for separate presentation.

**Question 13.1** Can a reporting entity apply the aggregation principle provided for VIE disclosures to the Variable Interest Model’s separate presentation requirement?

Presenting separate line items on a reporting entity’s statement of financial position for each VIE may be impractical for certain reporting entities that consolidate numerous VIEs with assets and liabilities that meet the criteria for separate presentation under ASC 810-10-45-25.

While not discussed with respect to separate presentation, the Variable Interest Model’s disclosure requirements include an aggregation principle (see Section 13.2.6). Specifically, the Variable Interest Model permits aggregation of disclosures for similar entities when separate reporting would not provide information that is more useful to financial statement users. We believe that a reporting entity that consolidates numerous VIEs could consider the aggregation principle for disclosure when applying the separate presentation requirement. Reporting entities should establish (and disclose) a policy for how similar entities are aggregated. That policy should contemplate both quantitative and qualitative information about the different risk and reward characteristics of each VIE and the significance of each VIE to the reporting entity.
For example, consider a reporting entity that is required to consolidate three VIEs (VIE 1, VIE 2 and VIE 3). Each of these VIEs has accounts receivable, investments and liabilities that meet the separate presentation requirement. The reporting entity determines that VIEs 1 and 2 are similar and, under its established policy, it is appropriate to aggregate the separate assets and liabilities of VIEs 1 and 2. In addition, the reporting entity determines that the aggregated presentation of each major class of assets and liabilities for VIEs 1 and 2 would provide information that is more useful to financial statement users. Accordingly, the reporting entity aggregates the receivables of VIEs 1 and 2, the investments of VIEs 1 and 2 and the liabilities of VIEs 1 and 2, respectively. In this example, the receivables, investments and liabilities of VIE 3 would be presented separately from those of the other VIEs.

**Question 13.2**
Can a reporting entity present the net assets of a VIE as a single line item on the statement of financial position? Alternatively, can a reporting entity present a VIE’s aggregate assets and aggregate liabilities?

No. While we believe that the aggregation of similar assets and liabilities of consolidated VIEs may be appropriate (as described in Question 13.1), we do not believe that a net presentation of a VIE’s assets and liabilities as one line item is acceptable. In addition, we believe that presenting a VIE’s aggregate assets and aggregate liabilities also is inconsistent with the separate presentation requirements in ASC 810-10-45-25.

**Illustration 13-1: Separate presentation on a net basis or single-line-item basis**

Assume Reporting entity A is the primary beneficiary of a VIE. The VIE’s assets and liabilities meet the criteria for separate presentation in the financial statements of Reporting entity A. The balance sheet of the VIE is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 100</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>200</td>
</tr>
<tr>
<td>PP&amp;E – net</td>
<td>300</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$ 150</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>400</td>
</tr>
<tr>
<td>Equity</td>
<td>50</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$ 600</td>
</tr>
</tbody>
</table>

**Analysis**

Because the Variable Interest Model does not provide detailed implementation guidance on separate presentation, reporting entities may choose different approaches to satisfy these requirements. For example, Reporting entity A may choose to present a separate line item for accounts receivable of the VIE, or it may choose to include the receivables of the VIE within its consolidated accounts receivable amount and parenthetically disclose the accounts receivable for the VIE. Other presentation alternatives may be acceptable.

Reporting entity A should not present a single line item for the VIE’s net asset value of $50 in its consolidated financial statements. Likewise, we believe that presenting the VIE’s aggregate assets and aggregate liabilities of $600 and $550, respectively, also is inconsistent with the separate presentation requirements in ASC 810-10-45-25.
13.2 Disclosures

All reporting entities with variable interests in VIEs are subject to the disclosure requirements of ASC 810.

13.2.1 Disclosure objectives

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidation — Overall</strong></td>
</tr>
<tr>
<td><strong>Disclosure — Variable Interest Entities</strong></td>
</tr>
<tr>
<td><strong>810-10-50-2AA</strong></td>
</tr>
<tr>
<td>The principal objectives of this Subsection’s required disclosures are to provide financial statement users with an understanding of all of the following:</td>
</tr>
<tr>
<td>a. The significant judgments and assumptions made by a reporting entity in determining whether it must do any of the following:</td>
</tr>
<tr>
<td>1. Consolidate a variable interest entity (VIE)</td>
</tr>
<tr>
<td>2. Disclose information about its involvement in a VIE.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>c. The nature of, and changes in, the risks associated with a reporting entity’s involvement with the VIE.</td>
</tr>
<tr>
<td>d. How a reporting entity’s involvement with the VIE affects the reporting entity’s financial position, financial performance, and cash flows.</td>
</tr>
<tr>
<td><strong>810-10-50-2AB</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>810-10-50-2AC</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

A reporting entity must consider the overall objectives in providing the disclosures required by the Variable Interest Model. To achieve these objectives, a reporting entity may need to supplement the required disclosures, depending on the facts and circumstances of the VIE and the reporting entity’s interest in that entity. Accordingly, if the reporting entity’s involvement with the VIE is not adequately described by any of the required disclosures, the reporting entity should provide further information, as needed.

The disclosure requirements are extensive and, for certain reporting entities, obtaining the information to prepare these disclosures may present challenges. Many VIEs do not prepare financial statements on a timely basis. The reporting entity also may not have a legal or contractual right to obtain the information, particularly when it holds a variable interest in a VIE but is not the VIE’s primary beneficiary. As a result, variable interest holders should ensure that they have access to the necessary information and develop
control procedures to be able to obtain and analyze the information in order to prepare the required disclosures. Developing the systems and processes necessary to gather the data may prove challenging, even for primary beneficiaries that have access to the information.

13.2.2 Primary beneficiaries of VIEs

Excerpt from Accounting Standards Codification

Consolidation — Overall

Disclosure — Variable Interest Entities

810-10-50-3

The primary beneficiary of a VIE that is a business shall provide the disclosures required by other guidance. The primary beneficiary of a VIE that is not a business shall disclose the amount of gain or loss recognized on the initial consolidation of the VIE. In addition to disclosures required elsewhere in this Topic, the primary beneficiary of a VIE shall disclose all of the following:

a. Subparagraph superseded by Accounting Standards Update No. 2009-17

b. Subparagraph superseded by Accounting Standards Update No. 2009-17

bb. The carrying amounts and classification of the VIE’s assets and liabilities in the statement of financial position that are consolidated in accordance with the Variable Interest Entities Subsections, including qualitative information about the relationship(s) between those assets and liabilities. For example, if the VIE’s assets can be used only to settle obligations of the VIE, the reporting entity shall disclose qualitative information about the nature of the restrictions on those assets.

c. Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the general credit of the primary beneficiary

d. Terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests that could require the reporting entity to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.

A VIE may issue voting equity interests, and the entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and the VIE’s assets can be used for purposes other than the settlement of the VIE’s obligations, the disclosures in paragraph 810-10-50-3(bb) through (d) are not required.

The disclosures described in paragraphs (bb), (c) and (d) of ASC 810-10-50-3 are required for the primary beneficiary of a VIE, regardless of whether the VIE meets the definition of a business. The primary beneficiary of a VIE also is required to provide the disclosures in ASC 810-10-50-5A (see Section 13.2.4). However, the FASB provided an exception to these requirements for VIEs that have 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 for purposes other than 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 other guidance. 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.
13.2.3 Holders of variable interests in VIEs that are not primary beneficiaries

Excerpt from Accounting Standards Codification

**Consolidation — Overall**

**Disclosure — Variable Interest Entities**

810-10-50-4

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:

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.

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.

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.

A reporting entity that holds a variable interest in a VIE but is not the VIE’s primary beneficiary is required to provide the disclosures in ASC 810-10-50-4 and 810-10-50-5A (see Section 13.2.4). Also, see Section 13.2.6 for guidance on aggregating certain disclosures.

**Question 13.3**

Does the term “maximum exposure to loss,” which must be disclosed pursuant to ASC 810-10-50-4(b), refer to economic risk or financial statement exposure?

We believe that “maximum exposure to loss” refers to the maximum loss that a reporting entity could be required to record in its income statement as a result of its involvement with a VIE. Further, this maximum potential loss must be disclosed regardless of the probability of such losses actually being incurred.
All holders of variable interests in VIEs

Excerpt from Accounting Standards Codification

Consolidation – Overall

Disclosure – Variable Interest Entities

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 810-10-25-48 through 25-54 and Example 4 (see paragraph 810-10-55-87) provide guidance on how to determine whether a reporting entity has an implicit variable interest in a VIE.

810-10-50-5B

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.

A reporting entity that has a variable interest in a VIE is required to provide the disclosures in paragraph ASC 810-10-50-5A, regardless of whether it is the VIE’s primary beneficiary. However, if the reporting entity is the primary beneficiary of the VIE, the FASB provided an exception to these disclosure requirements if 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 for purposes other than the settlement of the VIE’s obligations. Also, see Section 13.2.6 for guidance on aggregating certain disclosures.
13.2.5 **Scope-related disclosures**

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Disclosure — Variable Interest Entities**

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.

As described in Section 4.4.3, a reporting entity is not required to apply the provisions of the Variable Interest Model to entities created before 31 December 2003 if the reporting entity is unable to obtain information necessary to (1) determine whether the entity is a VIE, (2) determine whether the reporting entity is the VIE's primary beneficiary or (3) perform the accounting required to consolidate the VIE. If a reporting entity qualifies for this scope exception, it is required to provide the disclosures in paragraph ASC 810-10-50-6. See Section 4.4.3 for further guidance on this scope exception.

13.2.6 **Aggregation of certain disclosures**

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Disclosure — Variable Interest Entities**

810-10-50-9

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:

a. VIEs that are not consolidated because the reporting entity is not the primary beneficiary but has a variable interest

b. VIEs that are consolidated.

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.
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.

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

The qualitative information a reporting entity may consider to determine whether VIEs are similar includes, but is not limited to:

- The purpose and design of the VIE including the nature of the risks that the entity was designed to create. For example, the purpose and the design of a VIE may be to provide liquidity to the transferor of assets and to provide investors with the ability to invest in a pool of highly rated medium-term assets. Another VIE’s purpose and design may be to provide the lessee with use of the property for a certain number of years with substantially all of the rights and obligations of ownership. We believe aggregating disclosures based on the purpose and design of a VIE as described herein is appropriate and, therefore, the assets and liabilities of these two VIEs should not be aggregated.

- The nature of the assets in the VIE (e.g., residential mortgage vs. commercial mortgage).

- The type of involvement a reporting entity has with the VIE, including the reporting entity’s role (e.g., as a special servicer, a provider of guarantees or liquidity reserves) or the types of interests it holds (e.g., equity, debt).

We believe that the objective of the disclosure requirements is to provide more decision-useful information to users. Therefore, the manner in which a reporting entity applies the aggregation provisions should be consistent with this overall objective.

When considering whether to aggregate disclosures about multiple VIEs, a reporting entity should consider whether the disclosures are more informative on an aggregated or disaggregated basis from the perspective of a third party that is trying to understand the amount and nature of the reporting entity’s involvement with the VIEs. While disaggregated information may seem to be more useful in all cases, that may not be true when it results in excessive and lengthy disclosures. Also, it is important to remember that amounts related to VIEs that are consolidated should never be aggregated with amounts related to VIEs that are not consolidated.

A reporting entity is required to exercise judgment based upon its facts and circumstances in determining how much detail it should provide to satisfy the requirements of the Variable Interest Model.
13.2.7 Public company MD&A disclosure requirements

FR-67 requires a public company to provide disclosure in a separately captioned subsection of Management’s Discussion and Analysis (MD&A) of off-balance sheet arrangements that had a material effect on the financial statements presented or that are reasonably likely to have a material future effect on the company's financial statements or financial outlook.

We understand based on discussions with the SEC staff that these MD&A disclosures include obligations arising out of all variable interests in entities engaged in the activities specified in FR-67, even variable interests in entities that are not subject to the Variable Interest Model. For example, the scope of FR-67 can include obligations arising out of variable interests in an entity that is determined not to be a VIE after applying the provisions of the Variable Interest Model. (Note: The definition of a variable interest, in this context, is intended to be consistent with the concept of a variable interest included in the Variable Interest Model.)

Included within the definition of off-balance sheet arrangements in FR-67 are:

- Any retained or contingent interest in assets transferred to an unconsolidated entity
- Any similar arrangement that serves as credit, liquidity or market risk support to such an unconsolidated entity for transferred assets
- Obligations arising out of a material variable interest in an unconsolidated entity that either:
  - Provides financing, liquidity, market risk or credit risk support to the company
  - Engages in leasing, hedging or research and development services with the company

13.2.8 Private company accounting alternative

Private Companies can choose to be exempt from applying the Variable Interest Model to lessors in common control leasing arrangements that meet certain criteria but are subject to specific disclosure requirements. A private company is any entity that is not a public business entity, a not-for-profit entity or an employment benefit plan within the scope of ASC 960 through 965 on plan accounting. See Section 4.4.5 and Appendix D for further information.
14 Effective date and transition

14.1 Effective date

Excerpt from Accounting Standards Codification
Consolidation – Overall

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:

810-10-65-7

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.

For public business entities, ASU 2015-02 is effective for annual and interim periods beginning after 15 December 2015. For all other entities, it will be effective for annual periods beginning after 15 December 2016, and interim periods beginning after 15 December 2017. Early adoption is permitted for annual and interim periods. If an entity early adopts in an interim period, any adjustments that result from the adoption should be reflected as of the beginning of the fiscal year that includes the interim period.

It is important to note that the amendments to the Variable Interest Model are applicable to all reporting entities and to all entities with which those reporting entities are involved, regardless of when that involvement arose. Therefore, upon adoption of ASU 2015-02, all reporting entities must reconsider their consolidation conclusions for all entities with which they are involved.

14.2 Transition

Excerpt from Accounting Standards Codification
Consolidation – Overall

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:

810-10-65-7

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.

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.
14 Effective date and transition

14.2.1 Recognition

Upon transition, a reporting entity may be required to consolidate entities that it did not consolidate before the adoption of ASU 2015-02. Conversely, a reporting entity may be required to deconsolidate entities that it consolidated before the adoption of ASU 2015-02. In evaluating the effects of ASU 2015-02, a reporting entity should assume that ASU 2015-02’s requirements always have been effective. The determination of whether an entity is a VIE and which reporting entity, if any, is the VIE’s primary beneficiary should be made as of the date the reporting entity first became involved with the entity. That conclusion should then be reevaluated when events occur that change the determination of whether the entity is a VIE or the reporting entity is the primary beneficiary under ASU 2015-02 (see Section 14.2.2.1 for guidance on reconsideration events). However, a reporting entity should consolidate a VIE on the adoption date only if it would be a VIE’s primary beneficiary at the adoption date if ASU 2015-02’s provisions had always been applied. Alternatively, if the reporting entity would not be a VIE’s primary beneficiary at the adoption date if ASU 2015-02 had always been applied, the reporting entity should not consolidate the VIE on the adoption date.

Illustration 14-1: Reporting entity is not the primary beneficiary on the adoption date

Assume Company C, which has a calendar year-end, determines pursuant to ASU 2015-02 that it would have been the primary beneficiary of a collateralized debt obligation (CDO) when the CDO was created on 31 July 2005. Company C sells its only variable interest in the CDO on 1 December 2015 and concludes that it would no longer be the CDO’s primary beneficiary if ASU 2015-02 were adopted. No other events triggering reconsideration have occurred.

Analysis

If adopting ASU 2015-02 on 1 January 2016, Company C would not consolidate the CDO because it was not the primary beneficiary of the CDO on 31 December 2015 under ASU 2015-02. Company C would have deconsolidated the CDO under ASU 2015-02 when it sold its interest.

However, if Company C were to elect to retrospectively apply the provisions of ASU 2015-02, it would consolidate the CDO in the comparative financial statements until the sale of its interest.
14.2.2 Initial measurement when a reporting entity consolidates an entity

If a reporting entity is required to consolidate a VIE upon the adoption of ASU 2015-02, the reporting entity initially will measure and recognize all assets, liabilities and noncontrolling interests of the VIE at their carrying amounts at the date of adoption. Carrying amounts are the amounts at which the assets, liabilities and noncontrolling interests would have been carried in the consolidated financial statements if ASU 2015-02 was effective when the reporting entity first would have met the conditions to be the primary beneficiary under ASU 2015-02. Any differences between the net amounts added to the balance sheet upon initial consolidation and the amount of any previously recognized interest in the newly consolidated VIE should be recognized as a cumulative effect adjustment to retained earnings.

**Illustration 14-2: Consolidating a VIE upon the adoption of ASU 2015-02**

A reporting entity determines upon the adoption of ASU 2015-02 that it is the primary beneficiary of a VIE that was not previously consolidated. The reporting entity determines that it first met the conditions to be the primary beneficiary under ASU 2015-02 on 1 January 2005. The reporting entity also determines that the entity would have remained a VIE and that it would have remained the primary beneficiary under ASU 2015-02 through the date of adoption.

**Analysis**

The reporting entity initially calculates the fair values of all assets, liabilities and noncontrolling interests of the VIE at the date the reporting entity first met the conditions to be the primary beneficiary under ASU 2015-02. The reporting entity then subsequently adjusts those assets, liabilities and noncontrolling interests as if the entity were a consolidated subsidiary from 1 January 2005 to the date of adoption. The resulting amounts are recognized in consolidation at the date of adoption, with the difference between those amounts recognized as a cumulative effect adjustment to retained earnings.

It’s important to note that there are exceptions to fair value (e.g., transfers between entities under common control). Also, see Section 14.2.2.3 for certain practicability exceptions.

**Question 14.1** How should a reporting entity consider accumulated other comprehensive income (AOCI) in arriving at carrying amounts upon transition to ASU 2015-02?

While this is not addressed in the transition guidance to ASU 2015-02, we believe that a reporting entity should record any AOCI amounts at their carrying amounts at the date of adoption. For example, we believe it would be appropriate to include AOCI amounts for any foreign currency translation adjustments that would have been recorded from the date the reporting entity first would have been the primary beneficiary of a VIE under ASU 2015-02 to the date of adoption.

**Question 14.2** When determining carrying amounts, can a reporting entity designate a hedge relationship for the VIE from the inception of the derivative, even if it previously had not considered the provisions of ASC 815, including the documentation requirements?

No. We believe that hedge accounting is available as of the date that the relationship is formally designated and documented. For further discussion of hedge designation and documentation, see our *Financial reporting developments* publication, *Accounting for derivative instruments and hedging activities*. 
Illustration 14-3: Designating a hedge relationship in determining carrying amounts

Upon adoption of ASU 2015-02, Reporting entity A determines that it will consolidate VIE B. VIE B has never prepared financial statements in accordance with US GAAP. VIE B has a derivative that is an economic hedge on its fixed-rate debt; VIE B had entered into the derivative contract with an unrelated party before adopting ASU 2015-02. Because VIE B has never prepared US GAAP financial statements, it has never considered the provisions of ASC 815, including the documentation requirements.

Analysis

Reporting entity A must determine the carrying amounts of VIE B’s assets and liabilities from the date Reporting entity A originally would have been the primary beneficiary. In determining carrying amounts, Reporting entity A cannot designate a hedge relationship for VIE B from the inception of the derivative. We believe that hedge accounting should be evaluated under ASC 815 from the date of adoption of ASU 2015-02.

Question 14.3 What are the internal control over financial reporting (ICFR) requirements for entities consolidated as a result of adopting ASU 2015-02?

The SEC staff expressed the following views related to ICFR for entities consolidated as a result of adopting ASU 2015-02:

Speech Excerpts by SEC Staff

Center for Audit Quality (CAQ) SEC Regulations Committee – Joint meeting with SEC Staff
March 2015

If a registrant newly consolidates an entity as a result of the new standard, questions may arise about whether the registrant may exclude that entity from management’s assessment of internal control over financial reporting in the initial year of consolidation. Although FAQ #3 from the SEC staff’s “Management’s Report on Internal Control Over Financial Reporting (ICFR) and Certification of Disclosure in Exchange Act Periodic Reports (Frequently Asked Questions)” was not drafted to specifically address consolidation of VIEs, registrants may analogize to this FAQ under appropriate facts and circumstances. One factor to consider when making this determination is the period of time between the adoption date of ASU 2015-02 and the date of management’s assessment. The determination depends on a registrant’s specific facts and circumstances and the staff encouraged discussion with the staff prior to filing.

14.2.2.1 Reconsideration events

In accordance with ASC 810-10-65-7(g), the determinations of whether an entity is a VIE and which reporting entity, if any, is a VIE’s primary beneficiary is made as of (1) the date the reporting entity became involved with the entity or (2) the most recent reconsideration date if an event occurred that would change the determination of whether the entity is a VIE or the reporting entity is the primary beneficiary.
Illustration 14-4: Effect of prior period VIE reconsideration events on initial measurement

A reporting entity determines upon the adoption of ASU 2015-02 that it is the primary beneficiary of a VIE that was not previously consolidated. The reporting entity determines it first met the conditions to be the primary beneficiary under ASU 2015-02 on 1 January 2014. However, on 31 July 2015, an event occurred that would have required a reconsideration of the status of the entity as a VIE. After reconsideration, the entity is a VIE, and the reporting entity remains the primary beneficiary.

Analysis

The reconsideration event does not affect the measurement of assets, liabilities and noncontrolling interests because the entity’s status as a VIE does not change, and the reporting entity remains the primary beneficiary. The accounting is similar to Illustration 14-2. That is, the reporting entity initially calculates the fair values of all assets, liabilities and noncontrolling interests of the VIE at the date the reporting entity first met the conditions to be the primary beneficiary under ASU 2015-02, which is 1 January 2014. The reporting entity then subsequently adjusts those assets, liabilities and noncontrolling interests as if the entity were a consolidated subsidiary from 1 January 2014 to 1 January 2016 (the date of adoption).

Illustration 14-5: Effect of prior period VIE reconsideration events on initial measurement

Assume the same facts as in Illustration 14-4, except that certain events have occurred that would have required reconsideration of the entity’s VIE status on 1 May 2014. Under ASU 2015-02, the VIE would have been deconsolidated as of 1 May 2014.

Analysis

The determination of the carrying amounts upon adoption of ASU 2015-02 should be made starting with the reconsolidation on 31 July 2015. The reporting entity initially measures the VIE’s assets, liabilities and noncontrolling interests as of 31 July 2015 and rolls them forward to 1 January 2016 (the date of adoption) to determine the carrying amounts upon adoption of ASU 2015-02. The fact that the reporting entity was the primary beneficiary before 1 May 2014 does not affect the requirement for the reporting entity to initially measure the VIE’s assets, liabilities and noncontrolling interests as of 31 July 2015 when determining the carrying amounts upon adoption of ASU 2015-02.

14.2.2.2 Fair value option

A reporting entity that is required to consolidate a VIE as result of ASU 2015-02 may elect the fair value option for qualifying assets and liabilities of a newly consolidated VIE pursuant to ASC 825-10 but only as of the date that ASU 2015-02 becomes effective (i.e., the adoption date). A reporting entity may elect the fair value option for items of a VIE that are eligible for this option as long as it applies the election to all eligible items within the VIE. However, reporting entities may elect the fair value option on an entity-by-entity basis.

After transition, a reporting entity should follow the provisions of ASC 825-10 for newly consolidated VIEs. That is, for VIEs consolidated after the initial adoption of ASU 2015-02, the fair value option may be elected on an item-by-item basis and need not be consistently applied to all qualifying assets and liabilities of the newly consolidated VIE.

27 As discussed in paragraph A101 of the Basis for Conclusions to FAS 167, the FASB was concerned that allowing the fair value option on an instrument-by-instrument basis upon adoption of FAS 167 could result in reporting entities electing the option to achieve accounting results that are inconsistent with the objectives of ASC 825-10. ASU 2015-02 generally uses the same transition guidance as FAS 167.
A reporting entity electing the fair value option should disclose its rationale for electing the option for certain entities. If the fair value option is elected for some entities and not others, the reasons for those elections must be disclosed. Additionally, the consolidating reporting entity must disclose 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 an entity. Thus, a reporting entity must compare the amounts of the line items for which the fair value option is elected to the carrying amounts of the same line items (assuming determining carrying amounts is practical). After transition, a reporting entity will continue to be subject to the ongoing disclosure requirements of ASC 825-10.

**14.2.2.3 Practicability exceptions**

ASU 2015-02 provides practicability exceptions in applying the transition provisions with respect to both (1) recognition and (2) initial measurement when a reporting entity is required to consolidate an entity upon the adoption of ASU 2015-02.

Situations may arise in which it is not practicable for a reporting entity to determine whether an entity would have been a VIE or whether the reporting entity would have been the primary beneficiary if ASU 2015-02’s provisions had always been effective. That is, it may not be practicable for a reporting entity to determine whether an entity is a VIE or whether the reporting entity is the primary beneficiary from the date the reporting entity first became involved with an entity, or if a reconsideration has occurred, at the most recent reconsideration date. In these situations, the reporting entity should make the determination of whether it should consolidate an entity as of the effective date of ASU 2015-02. That is, a reporting entity that uses the practicability exception performs the VIE and primary beneficiary analysis as of a different date (the adoption date).

There also may be situations in which it is not practicable to determine carrying amounts. In those situations, the assets, liabilities and noncontrolling interests of the VIE should be measured at fair value at the date of adoption. However, if a VIE’s primary beneficiary changes between entities that are under common control, we believe that the new primary beneficiary should initially measure the assets, liabilities and noncontrolling interests of the VIE at carryover basis. In addition, we believe that when a reporting entity 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, the primary beneficiary should initially measure those transferred assets and liabilities (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 (see Chapter 12).

When determining the carrying amounts of assets, liabilities and noncontrolling interests is not practicable, ASU 2015-02 provides an additional measurement alternative for certain assets. If the activities of the VIE are primarily related to securitizations or other forms of asset-backed financings, and the assets of the VIE can be used only to settle obligations of the VIE, the reporting entity may choose to measure the assets and liabilities of the VIE at their unpaid principal balance upon adoption of ASU 2015-02. The primary beneficiary also must consider the need to recognize accrued interest, allowances for credit losses or other-than-temporary impairments, as appropriate, under this measurement alternative. It is important to note that in these circumstances, other assets, liabilities or noncontrolling interests, if any, that do not have an unpaid principal balance, and any items that are required to be carried at fair value under other applicable standards, should be measured at fair value. The FASB intends for the additional transition measurement alternative to be available in situations when a reporting entity would need to incur excessive costs and effort to determine carrying amounts of a consolidated entity’s assets, liabilities and noncontrolling interests.

---

28 Carryover basis is the amount at which the assets, liabilities and noncontrolling interests were carried in the accounts of reporting entity that formerly consolidated the VIE (i.e., carryover basis should be used with no adjustment to current fair values and no gain or loss should be recognized).
Question 14.4  How should a reporting entity determine whether it is not practicable to apply the recognition or measurement provisions in ASU 2015-02?

The Variable Interest Model does not define “not practicable.” We believe the following factors should be considered in assessing whether it is impracticable to apply ASU 2015-02’s transition provisions:

- Whether data was collected in prior periods in a way that allows retrospective application or, if not, whether it is impracticable to recreate the data in a manner that supports retrospective application

- Whether applying the provisions of ASU 2015-02 requires management to use hindsight, either in making assumptions about what its intentions would have been in a prior period or estimating the amounts recognized, measured or disclosed (e.g., an estimate of fair value based on inputs that are not derived from observable market sources and were not used for other accounting measurements at that time)

- Whether in light of the expected costs and perceived benefits, retrospective application would involve undue cost and effort

Given the challenges that some may face in applying ASU 2015-02’s transition provisions, we believe that reporting entities may use ASU 2015-02’s practicability exceptions with some frequency. If an entity concludes that applying ASU 2015-02’s transition provisions are impracticable, we would expect this conclusion to be supported by a thoroughly documented analysis. See further details about the practicability exception related to deconsolidation in Section 14.2.3.

Question 14.5  Is the practicability exception with respect to measurement of assets, liabilities and noncontrolling interests available on an entity-by-entity basis?

Yes. We believe the practicability exception with respect to measurement can be applied on an entity-by-entity basis.

### Illustration 14-6: Practicability exception available on an entity-by-entity basis

Upon adoption of ASU 2015-02, Company A determines it is required to consolidate three VIEs (VIE 1, VIE 2 and VIE 3) that were not previously consolidated. Company A became involved with VIEs 1, 2 and 3 on 1 January 2006, 1 July 2007 and 15 May 2015, respectively. Company A further concludes that it can determine the carrying amounts for VIE 3, but it is not practicable to do so for VIEs 1 and 2.

**Analysis**

Company A will initially measure the assets, liabilities and noncontrolling interests of VIE 3 as of 15 May 2015. Company A then would roll forward to the adoption date the carrying amounts of the assets, liabilities and noncontrolling interests of VIE 3. With respect to VIE 1 and VIE 2, Company A will initially measure the assets, liabilities and noncontrolling interests at fair value at the date of adoption. Company A recognizes any differences between the net amounts added to the balance sheet upon initial consolidation and the amount of any previously recognized interests in the newly consolidated VIEs as a cumulative effect adjustment to retained earnings.
Question 14.6  If the activities of the VIE are primarily related to securitizations or other forms of asset-backed financings and the assets of the VIE can be used only to settle obligations of the VIE, can a reporting entity measure the assets and liabilities of the VIE at their unpaid principal balances in all circumstances?

Before the reporting entity can elect to measure the VIE’s eligible assets, liabilities and noncontrolling interests at their unpaid principal balances, the reporting entity first must establish that it is not practicable to measure the assets, liabilities and noncontrolling interests of the VIE at their carrying amounts.

The primary beneficiary also must consider the need to recognize accrued interest, allowances for credit losses or other-than-temporary impairments, as appropriate, under this measurement alternative. In addition, other assets, liabilities or noncontrolling interests, if any, that do not have an unpaid principal balance, and any items that are required to be carried at fair value under other applicable standards, must be measured at fair value.

14.2.3 Initial measurement when a reporting entity deconsolidates an entity

If a reporting entity is required to deconsolidate an entity upon the adoption of ASU 2015-02, the deconsolidating reporting entity should initially measure any retained interest in the deconsolidated entity at its carrying amount upon adoption. Carrying amount refers to the amount at which any retained interest would have been carried in the reporting entity’s financial statements if ASU 2015-02 had been effective when the reporting entity became involved with the entity or no longer met the conditions to be the primary beneficiary.

Any difference between the net amount removed from the balance sheet of the deconsolidating reporting entity and the amount of any retained interest in the deconsolidated 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 cumulative effect adjustments related to consolidation.

Illustration 14-7:  Deconsolidating a VIE upon the adoption of ASU 2015-02

A reporting entity determines upon the adoption of ASU 2015-02 that it is not the primary beneficiary of an entity that was previously consolidated. The reporting entity became involved with the entity on 1 January 2014. In considering ASU 2015-02, the entity concludes that it would have accounted for its initial investment under the equity method in accordance with ASC 323-10.

Analysis

The reporting entity calculates its initial investment at cost in accordance with the equity method of accounting on 1 January 2014. The reporting entity then subsequently adjusts the investment balance in accordance with the equity method of accounting to the date of adoption of ASU 2015-02. The amount resulting from these calculations through the adoption date is recognized on the reporting entity’s balance sheet at the date of adoption, all assets and liabilities previously recognized through consolidation of the entity are derecognized, and the difference is recognized as a cumulative effect adjustment to retained earnings.

ASU 2015-02 provides a practicability exception related to deconsolidation. A reporting entity that concludes that it is not practicable to determine the carrying amount of the retained interest in a deconsolidated entity may measure it at fair value at the date of adoption. We believe that a reporting entity that has historically consolidated an entity would typically have access to the information necessary to determine the carrying amounts of the retained interest in the deconsolidated entity. Therefore, we believe entities will rarely use this practicability exception.
Question 14.7 Should accounting standards that may not have been effective when a reporting entity first became involved with an entity (or no longer met the conditions to be the primary beneficiary) be applied in determining carrying amounts upon transition to ASU 2015-02?

We do not believe the FASB intended to require the adoption of accounting standards before their effective date. Therefore, we believe that when a reporting entity is required to determine carrying amounts, it should apply a new accounting standard and roll forward carrying amounts from the date at which the new accounting standard is effective. However, see Section 14.2.2 for an exception regarding the initial measurement of consolidated VIEs.

Question 14.8 How should a reporting entity apply accounting standards that require an assessment of management’s intent or application of judgment retrospectively in the determination of carrying amounts?

ASU 2015-02 does not provide detailed implementation guidance on the determination of initial measurement and subsequent accounting in computing carrying amounts upon adoption. Therefore, application of standards that require judgment or an assessment of management’s intent will require careful consideration in rolling forward initial amounts when determining the cumulative effect adjustment.

Illustration 14-8: Application of judgment retrospectively in determining carrying amounts

A reporting entity determines upon the adoption of ASU 2015-02 that it is not the primary beneficiary of an entity that was previously consolidated. The reporting entity became involved with the entity on 1 January 2014. In considering ASU 2015-02, the entity concludes that it would have accounted for its initial investment under the equity method in accordance with ASC 323. Therefore, the reporting entity calculates its initial investment at cost in accordance with the equity method of accounting on 1 January 2014. The reporting entity is required to subsequently adjust the initial investment balance in accordance with the equity method of accounting to the date of adoption of ASU 2015-02.

Analysis

In subsequently adjusting the investment balance in accordance with the equity method of accounting to the date of adoption of ASU 2015-02, a reporting entity may encounter circumstances that require judgment. For example, in rolling forward the initial investment balance, the reporting entity may be required to evaluate whether the equity-method investment is other-than-temporarily impaired. A reporting entity should carefully evaluate how accounting standards that require judgment or an assessment of management’s intent should be applied in the determination of carrying amounts.

Those judgments should be based on information that was available at that time. For example, it would be inappropriate to recognize an impairment charge based solely on subsequent events that could not have been known on the impairment assessment date.
14.2.4 Retrospective application

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidation – Overall</td>
</tr>
<tr>
<td>Transition and Open Effective Date Information – Variable Interest Entities</td>
</tr>
</tbody>
</table>

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.

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.

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.

ASU 2015-02 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. If a reporting entity restates its financial statements, we believe the restatement should include all VIEs of which the reporting entity was the primary beneficiary during the restated period, even if it was not the primary beneficiary of the VIEs at the date of adoption. Additionally, we believe that when restating to make the periods comparable, a reporting entity should consider the appropriateness of providing the disclosures required by ASC 250.

Illustration 14-9: Retrospective application

Company Y, a calendar year-end company, would have been the primary beneficiary of two VIEs under ASU 2015-02 when they were created in 2012. Company Y determines at 1 January 2016 (the date of adoption) that it is still the primary beneficiary of VIE 1 under ASU 2015-02 but, because it sold all of its variable interests in VIE 2 on 31 May 2014, it would no longer be VIE 2’s primary beneficiary under ASU 2015-02.

Analysis

If Company Y elects to retrospectively apply ASU 2015-02 to previously issued financial statements with a cumulative effect adjustment at 1 January 2014, Company Y’s financial statements should reflect the consolidation of VIE 1 for 2014 and 2015 and VIE 2 through 31 May 2014, the date at which Company Y was no longer the primary beneficiary.
### SEC reporting implications of adopting ASU 2015-02

The SEC staff shared the following views about the reporting implications of adopting ASU 2015-02:

<table>
<thead>
<tr>
<th>Speech Excerpts by SEC Staff</th>
</tr>
</thead>
<tbody>
<tr>
<td>Center for Audit Quality (CAQ) SEC Regulations Committee – Joint meeting with SEC Staff</td>
</tr>
<tr>
<td>March 2015</td>
</tr>
</tbody>
</table>

Registrants who apply the new requirements retrospectively will need to assess the need to revise the historical financial statements in connection with a new or amended registration statement/proxy statement (e.g., pursuant to Item 11 of Form S-3).

Registrants who adopt the standard retrospectively are not required to revise any periods not covered by their audited financial statements. For example, if the registrant has revised the most recent three years in its audited financial statements as a result of adopting the new standard, the registrant is not required to also revise the earliest two years in the selected financial data table.

Item 2.01 of Form 8-K, Completion of Acquisition or Disposition of Assets, would not be triggered if the adoption of the standard requires the registrant to newly consolidate or deconsolidate an entity. However, if consolidation or deconsolidation occurs as the result of a reconsideration event subsequent to the initial adoption of the standard, registrants would need to consider the requirements of Item 2.01 of Form 8-K. See the Highlights from the June 2009 and June 2011 Joint Meetings and CAQ Alert 2010-20.
A Expected losses and expected residual returns

A.1 Introduction

The Variable Interest Model has become increasingly more qualitative than the previous model under FIN 46(R). FAS 167 eliminated the requirement to calculate expected losses and expected residual returns to determine the primary beneficiary of a VIE. The current model focuses on identifying the reporting entity with power to make the decisions that most significantly impact a VIE’s economic performance. However, in certain circumstances, a reporting entity may still have to calculate expected losses and expected residual returns to determine whether an entity is a VIE. See Chapter 7 for guidance on determining whether an entity is a VIE.

A.2 Expected losses, expected residual returns and expected variability

Excerpt from Accounting Standards Codification

Consolidation – Overall

Glossary

810-10-20

Expected Losses

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

Expected Residual Returns

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

Expected Losses and Expected Residual Returns

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

Expected Variability

Expected variability is the sum of the absolute values of the expected residual return and the expected loss. Expected variability in the fair value of net assets includes expected variability resulting from the operating results of the legal entity.
The Variable Interest Model's concepts of expected losses and expected residual returns are difficult to understand and to apply. That's because expected losses are not GAAP or economic losses expected to be incurred by an entity, and expected residual returns are not GAAP or economic income expected to be earned by an entity. Instead, expected losses and expected residual returns are derived from projected cash flow techniques described in CON 7. That is, they are measures of the variability (or risk) inherent in the fair value of a particular entity. The Variable Interest Model refers to negative variability as “expected losses” and positive variability as “expected residual returns.”

Because expected losses and expected residual returns represent the potential variability from the expected cash flows of an entity, all entities that have the potential for multiple possible outcomes will have expected losses. Even entities that have a history of profitable operations and expect to be profitable in the future have expected losses.

**Illustration A-1: Expected losses**

An entity has generated net income of $10 million to $13 million in each of its 10 years of operation. At 31 December 20X9, the entity is expected to generate average net income of $14 million annually over the next few years. Although the entity is expected to remain profitable, its future net income is an estimate that has uncertainty or variability associated with it. The variability is the source of expected losses. In developing its estimate of average future net income, assume the entity believes its net income could vary between $12 million and $16 million as follows:

- **Expected losses**
  - $12 million
  - $14 million
  - $16 million

- **Expected residual returns**
  - $14 million

Although the entity has been profitable historically and is expected to remain profitable, it has expected losses because there is variability around its mean, or expected outcome, of $14 million. Any possible outcome with net income of less than $14 million gives rise to expected losses. Conversely, any possible outcome that produces more than $14 million of net income gives rise to expected residual returns.

**Calculating expected losses and expected residual returns**

To calculate expected losses and expected residual returns, a reporting entity first must calculate the fair value of an entity’s net assets. The fair value of an asset traditionally has been determined by discounting the asset’s contractual cash flows at a risk-adjusted rate that reflects the uncertainty in the amount and timing of their collection (we refer to this as the “traditional approach”). However, expected losses and expected residual returns are not derived using the traditional approach. Instead, they are derived using techniques described in CON 7. CON 7 provides general principles that govern the use of present value and introduces the expected cash flow approach.
Under the expected cash flow approach, the fair value of an entity’s net assets equals the mean of a distribution of possible cash flow outcomes that are probability-weighted and discounted. That is, each possible cash flow outcome is multiplied by its probability of occurrence. These amounts are then discounted using the interest rate on the appropriate default-risk-free investment (i.e., the risk-free rate) corresponding to the time horizon of the projected cash flows.

The possible cash flow outcomes should be based on different assumptions that are likely to significantly affect the entity’s results of operations or the fair value of its assets. The risk-free rate is used because all significant risks relating to the cash flows, and the manner in which those risks might affect the amount and timing of the cash flows, are explicitly considered in estimating the possible cash flow outcomes and assigning a probability factor to each. Use of a risk-adjusted interest rate for discounting instead of the risk-free rate may disguise a portion of an entity’s potential variability and could result in an inappropriate conclusion about whether an entity is a VIE, even if multiple outcomes are projected for an entity.

The FASB believes the expected cash flow approach is preferable because the assumptions about possible outcomes can be examined individually. This cannot be done under the traditional approach, which uses a single cash flow estimate and a risk-adjusted interest rate to reflect uncertainty. The expected cash flow approach also results in projections that demonstrate how differing assumptions change the timing and amount of cash flows available to the entity’s variable interest holders, making it possible to quantify the potential variability in the entity’s returns.

After a reporting entity calculates the fair value of an entity’s net assets, it can calculate an entity’s expected losses and expected residual returns. Expected losses and expected residual returns are calculated by subtracting the present value of each possible outcome from the expected outcome and multiplying the difference by the possible outcome’s probability of occurrence. Because expected losses and expected residual returns are calculated based on the variability from the expected outcome, the absolute values of expected losses and expected residual returns should be equal.

**Question A.1**

The Codification defines an entity’s expected losses (and expected residual returns) as the expected negative variability (and expected positive variability) in the fair value of the entity’s net assets, exclusive of variable interests. What does the phrase “exclusive of variable interests” mean?

When calculating expected losses and expected residual returns, possible outcomes should be based on an entity’s projected cash inflows and outflows that arise from sources other than the variable interests in the entity (i.e., the cash flows that arise from an entity’s creators of variability). Cash flows to or from variable interest holders are not included in developing the outcomes because these cash flows serve as the basis for allocating the entity’s expected losses and expected residual returns to the variable interest holders.
Illustration A-2: Calculating expected losses and expected residual returns

Example 1

An entity is capitalized with debt and equity and uses the proceeds to purchase a building. The entity enters into a contract with a management company to manage the day-to-day operations of the building. Assume that the management contract is not a variable interest and that the lender and the equity investor are the only variable interest holders in the entity.

In developing the first year’s possible outcomes, the following anticipated cash flows were considered:

- Cash inflows from building (e.g., rent) \( \$1,000 \)
- Cash outflows to non-variable interest holders (e.g., management contract fee) \((200)\)
- Cash available to variable interest holders \(\$800\)

The $800 is used to estimate possible cash flow outcomes. (The entity’s cash outflows related to interest incurred on the debt and any payments to the equity holders were not deducted when determining the entity's possible cash flow outcomes because the loan and equity investments are variable interests in the entity.)

Example 2

Assume a cash flow of $1,000 (i.e., cash available to variable interest holders) is expected to be received in one, two or three years with probabilities of 10%, 60% and 30%, respectively.

<table>
<thead>
<tr>
<th>Possible outcome (a)</th>
<th>Probability (b)</th>
<th>Weighted possible outcome (a*b)=(c)</th>
<th>Fair value1 (d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$1,000</td>
<td>10%</td>
<td>$100</td>
</tr>
<tr>
<td>Year 2</td>
<td>$1,000</td>
<td>60%</td>
<td>600</td>
</tr>
<tr>
<td>Year 3</td>
<td>$1,000</td>
<td>30%</td>
<td>300</td>
</tr>
<tr>
<td></td>
<td></td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

1 Represents the weighted possible outcome discounted at the interest rate on default risk-free investments, which is assumed to be 5% for all years.

The timing of the cash flows associated with the three outcomes is uncertain. Under CON 7’s expected cash flow approach, each possible outcome of $1,000 is multiplied by its probability of occurrence and then discounted to present value using the interest rate on the corresponding default-risk-free investment. The sum of these amounts ($898.61) is referred to as the expected outcome and approximates the fair value of the entity's net assets.

To calculate expected losses and expected residual returns, the present value of each possible outcome is subtracted from the expected outcome and the difference is multiplied by the possible outcome’s probability of occurrence.
A.3.1 Effect of variable interests in specified assets or silos

A reporting entity may hold a variable interest that is related to a specific asset or group of assets of an entity and does not have a variable interest in the entity as a whole. See Chapters 5 and 6 for determining whether a variable interest is related to a specific asset or group of assets of an entity.

In this situation, the expected losses absorbed by the variable interests in the specified assets are excluded when determining whether the entity has sufficient equity at risk. In other words, in determining whether an entity has sufficient equity to finance its activities, the equity holders do not have to support the expected losses that are absorbed by variable interest holders that hold interests only in specified assets of the entity.

Similarly, if a reporting entity has an interest in a silo of an entity, the expected losses absorbed by the variable interests in the silo are excluded when determining whether the host entity has sufficient equity at risk. However, a key distinction is that a silo can be consolidated separately from the host entity when the host entity is a VIE. That is, a reporting entity with a variable interest in a silo is subject to consolidating the assets, liabilities and equity of that silo separate from the host VIE.

Section A.8 provides an example of how interests in specified assets and silos affect the calculation of expected losses and expected residual returns for an entity.

A.4 Allocation of expected losses and expected residual returns

In some situations, it may be necessary to allocate expected losses and residual returns to an entity's variable interest holders. For example, a reporting entity may find this allocation necessary to assess whether an entity is a VIE under the anti-abuse clause. As a reminder, Condition 1 of the anti-abuse clause requires a reporting entity to determine whether the voting rights of some investors are disproportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns or both (see Chapter 7).
To perform this calculation, we believe a reporting entity should allocate an entity’s possible cash flow outcomes (both in amount and priority) to the entity’s variable interest holders according to the contractual arrangements among the parties. The possible outcomes for each variable interest holder are then multiplied by their probability of occurrence and discounted using the risk-free rate to determine the fair value (or expected outcome) of each holder’s variable interest. Expected losses and expected residual returns are calculated by subtracting the present value of each possible outcome from the expected outcome and multiplying the difference by its probability of occurrence.

We believe this approach to allocating an entity’s possible outcomes to each variable interest holder and then calculating each holder’s expected losses and expected residual returns best accommodates the complex distribution agreements that commonly exist today. For example, many structures provide for profits to be distributed to equity holders based on their relative ownership interest until one equity holder achieves a stated rate of return, at which point the profits are allocated differently to provide one of the equity owners with an incentive to achieve superior performance.

Illustration A-3: Allocation of expected losses and expected residual returns

Assume an entity issues $800,000 of par value zero-coupon debt that matures in one year to a reporting entity for $733,333. Another reporting entity invests $23,810 and receives all of the entity’s equity. The total proceeds of $757,143 are invested in a pool of assets. All of the entity’s assets will be liquidated at the end of one year. The interest rate on default-risk-free investments is 5%.

Table 1 shows the entity’s possible outcomes (column a), the probabilities associated with these outcomes (column b) and how the outcomes are allocated to the debt holder (column c) and the equity holder (column d). The debt holder receives all of the VIE’s cash flows up to $800,000, at which point the debt has been repaid and any further cash flows will be received by the equity holder.

<table>
<thead>
<tr>
<th>Possible outcomes</th>
<th>Probability</th>
<th>Outcomes to:</th>
<th>Debt</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>$650,000</td>
<td>5%</td>
<td>$650,000</td>
<td>700,000</td>
<td>$</td>
</tr>
<tr>
<td>700,000</td>
<td>10%</td>
<td>700,000</td>
<td>750,000</td>
<td></td>
</tr>
<tr>
<td>750,000</td>
<td>25%</td>
<td>800,000</td>
<td>800,000</td>
<td></td>
</tr>
<tr>
<td>800,000</td>
<td>25%</td>
<td>800,000</td>
<td>800,000</td>
<td>50,000</td>
</tr>
<tr>
<td>850,000</td>
<td>20%</td>
<td></td>
<td></td>
<td>100,000</td>
</tr>
<tr>
<td>900,000</td>
<td>15%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 2 shows how expected losses and expected residual returns for the debt holder are calculated. The present value of each possible outcome is compared with the fair value of the debt holder’s variable interest ($733,334). That difference is multiplied by the probability of occurrence to compute the debt holder’s expected losses and expected residual returns. For example, in the possible outcome where $650,000 is received from the entity’s assets, all of the cash flows would be allocated to the debt holder. The present value of that outcome is $619,048 ($650,000 discounted at the assumed risk-free rate of 5%). The difference between this amount and the fair value is multiplied by the probability of occurrence (5%), which results in an expected loss of $5,714.
Table 2 – Debt holder expected losses and expected residual returns

<table>
<thead>
<tr>
<th>Present value of possible outcomes</th>
<th>Probability</th>
<th>Fair value</th>
<th>Expected losses</th>
<th>Expected residual returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>(c) = (c)/(1+RF rate)</td>
<td>(b)</td>
<td>(e*b)</td>
<td>(e-f)*b</td>
<td></td>
</tr>
<tr>
<td>$619,048</td>
<td>5%</td>
<td>$30,952</td>
<td>$5,714</td>
<td>$ –</td>
</tr>
<tr>
<td>666,667</td>
<td>10%</td>
<td>$66,667</td>
<td>(6,667)</td>
<td>$ –</td>
</tr>
<tr>
<td>714,286</td>
<td>25%</td>
<td>$178,572</td>
<td>(4,762)</td>
<td>$7,143</td>
</tr>
<tr>
<td>761,905</td>
<td>25%</td>
<td>$190,476</td>
<td>$ –</td>
<td>$5,714</td>
</tr>
<tr>
<td>761,905</td>
<td>20%</td>
<td>$152,381</td>
<td>–</td>
<td>$5,714</td>
</tr>
<tr>
<td>761,905</td>
<td>15%</td>
<td>$114,286</td>
<td>–</td>
<td>$4,286</td>
</tr>
<tr>
<td>733,334</td>
<td></td>
<td>$733,334</td>
<td>(f)</td>
<td>$17,143</td>
</tr>
</tbody>
</table>

Table 3 shows how expected losses and expected residual returns are computed for the equity holder. This computation is consistent with the computations presented in Table 2.

Table 3 – Equity holder cash flow variability

<table>
<thead>
<tr>
<th>Present value of possible outcomes</th>
<th>Probability</th>
<th>Fair value</th>
<th>Expected losses</th>
<th>Expected residual returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>(g) = (d)/(1+RF rate)</td>
<td>(b)</td>
<td>(g*b)</td>
<td>(g-h)*b</td>
<td></td>
</tr>
<tr>
<td>$ –</td>
<td>5%</td>
<td>$ –</td>
<td>$1,191</td>
<td>$ –</td>
</tr>
<tr>
<td>$ –</td>
<td>10%</td>
<td>$ –</td>
<td>$2,381</td>
<td>$ –</td>
</tr>
<tr>
<td>$ –</td>
<td>25%</td>
<td>$ –</td>
<td>$5,952</td>
<td>$ –</td>
</tr>
<tr>
<td>$ –</td>
<td>25%</td>
<td>$ –</td>
<td>$5,952</td>
<td>$ –</td>
</tr>
<tr>
<td>47,619</td>
<td>20%</td>
<td>9,524</td>
<td>$ –</td>
<td>4,762</td>
</tr>
<tr>
<td>95,238</td>
<td>15%</td>
<td>14,286</td>
<td>$ –</td>
<td>10,714</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$23,810</td>
<td>(h)</td>
<td>$15,476</td>
</tr>
</tbody>
</table>

The expected losses and expected residual returns of the variable interest holders, and of the entity, may be summarized as follows:

<table>
<thead>
<tr>
<th>Expected losses</th>
<th>Expected residual returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt holder (Table 2)</td>
<td>$ (17,143)</td>
</tr>
<tr>
<td>Equity holder (Table 3)</td>
<td>(15,476)</td>
</tr>
<tr>
<td>Total variable interests</td>
<td>$ (32,619)</td>
</tr>
</tbody>
</table>

Generally, the sum of the expected losses and expected residual returns of the variable interest holders in an entity will exceed the expected losses and residual returns of the entity. This occurs if one or more variable interests in an entity have a senior priority to other variable interests. The most common example is debt and preferred stock holders, which have a senior priority to common equity holders.

We believe that the expected losses and expected residual returns of the variable interest holders must equal the expected losses and expected residual returns of the entity. Therefore, for each possible outcome in which one variable interest holder experiences an expected loss while other variable interest holders experience an expected residual return, a reporting entity should reallocate the expected losses and expected residual returns of those variable interest holders using one of two common approaches. See Illustration A-4 for guidance on these two approaches.
Illustration A-4: Sum of expected losses and expected residual returns of variable interest holders exceed those of the entity

Assume an entity has the following possible cash flow outcomes and related expected losses and expected residual returns:

<table>
<thead>
<tr>
<th>Possible outcomes</th>
<th>Expected losses</th>
<th>Expected residual returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 650,000</td>
<td>$ (6,905)</td>
<td>$ -</td>
</tr>
<tr>
<td>700,000</td>
<td>(9,048)</td>
<td>-</td>
</tr>
<tr>
<td>750,000</td>
<td>(10,714)</td>
<td>-</td>
</tr>
<tr>
<td>800,000</td>
<td>-</td>
<td>1,191</td>
</tr>
<tr>
<td>850,000</td>
<td>-</td>
<td>10,476</td>
</tr>
<tr>
<td>900,000</td>
<td>-</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total VIs</strong></td>
<td><strong>(26,667)</strong></td>
<td><strong>26,667</strong></td>
</tr>
</tbody>
</table>

Further assume the entity has two variable interest holders, a senior debt holder and an equity holder. The expected losses and expected residual returns of each variable interest holder are as follows (see Illustration A-3 for how these amounts are calculated):

<table>
<thead>
<tr>
<th>Possible outcomes</th>
<th>Debt holder</th>
<th>Equity holder</th>
<th>Total VIs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Expected losses</td>
<td>Expected residual returns</td>
<td>Expected losses</td>
</tr>
<tr>
<td>$ 650,000</td>
<td>$ (5,714)</td>
<td>$ -</td>
<td>$ (1,191)</td>
</tr>
<tr>
<td>700,000</td>
<td>(6,667)</td>
<td>-</td>
<td>(2,381)</td>
</tr>
<tr>
<td>750,000</td>
<td>(4,762)</td>
<td>-</td>
<td>(5,952)</td>
</tr>
<tr>
<td>800,000</td>
<td>-</td>
<td>7,143</td>
<td>(5,952)</td>
</tr>
<tr>
<td>850,000</td>
<td>-</td>
<td>5,714</td>
<td>-</td>
</tr>
<tr>
<td>900,000</td>
<td>-</td>
<td>4,286</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total VIs</strong></td>
<td><strong>(17,143)</strong></td>
<td><strong>17,143</strong></td>
<td><strong>(15,476)</strong></td>
</tr>
</tbody>
</table>

As shown above, the sum of the expected losses and expected residual returns of the variable interest holders ($32,619) exceeds those of the entity ($26,667). This difference arises because for a possible outcome of $800,000, the debt holder receives an expected residual return of $7,143, while the equity holder absorbs an expected loss of $5,952. Therefore, we believe the expected losses and expected residual returns of the variable interest holders for this possible outcome should be reallocated to make the total expected losses and expected residual returns of the variable interest holders equal to those of the entity.

Approach 1

The table below demonstrates one approach to reallocating the expected losses and expected residual returns of the variable interest holders. Under this approach, a portion of expected residual returns are reallocated to expected losses.

The amount of expected residual returns that should be reallocated is an amount equal to the lesser of (1) the sum of the expected losses absorbed by the subordinated interests or (2) the sum of the expected residual returns inuring to the senior interests. The reallocation process should begin with the most senior variable interest holder(s) that received an expected residual return and continue until the appropriate amount has been reallocated.
A Expected losses and expected residual returns

Financial reporting developments

Consolidation and the Variable Interest Model | A-9

This approach is demonstrated in the shaded portions of the table below:

<table>
<thead>
<tr>
<th>Potential outcome</th>
<th>Debt holder</th>
<th>Equity holder</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Expected losses</td>
<td>Expected residual returns</td>
<td>Expected losses</td>
</tr>
<tr>
<td>$ 650,000</td>
<td>$ (5,714)</td>
<td>$</td>
<td>$ (1,191)</td>
</tr>
<tr>
<td>700,000</td>
<td>(6,667)</td>
<td>-</td>
<td>(2,381)</td>
</tr>
<tr>
<td>750,000</td>
<td>(4,762)</td>
<td>-</td>
<td>(5,952)</td>
</tr>
<tr>
<td>800,000</td>
<td>5,952</td>
<td>1,191</td>
<td>(5,952)</td>
</tr>
<tr>
<td>850,000</td>
<td>-</td>
<td>5,714</td>
<td>-</td>
</tr>
<tr>
<td>900,000</td>
<td>4,286</td>
<td>-</td>
<td>10,714</td>
</tr>
<tr>
<td></td>
<td>(11,191)</td>
<td>(11,191)</td>
<td>(15,476)</td>
</tr>
</tbody>
</table>

For a possible outcome of $800,000, the sum of the expected losses absorbed by the subordinated interests is $5,952 and the sum of the expected residual returns inuring to the senior interests is $7,143. Therefore, the lesser of these amounts ($5,952) is the amount of expected residual returns that should be reallocated, beginning with the most senior variable interest holder that received an expected residual return (the debt holder in this illustration). After this adjustment, the sum of the expected losses and expected residual returns of the variable interest holders ($26,667) equals those of the entity ($26,667).

Approach 2

Under a second approach, the entity’s result for each possible outcome serves as a control. For example, if the entity experienced an expected loss for a possible outcome, all amounts for each variable interest holder should be reflected as an expected loss. This would require any expected residual returns of the variable interest holders to be reallocated to expected losses.

This approach is demonstrated in the shaded portions of the table below:

<table>
<thead>
<tr>
<th>Potential outcome</th>
<th>Debt holder</th>
<th>Equity holder</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Expected losses</td>
<td>Expected residual returns</td>
<td>Expected losses</td>
</tr>
<tr>
<td>$ 650,000</td>
<td>$ (5,714)</td>
<td>$</td>
<td>$ (1,191)</td>
</tr>
<tr>
<td>700,000</td>
<td>(6,667)</td>
<td>-</td>
<td>(2,381)</td>
</tr>
<tr>
<td>750,000</td>
<td>(4,762)</td>
<td>-</td>
<td>(5,952)</td>
</tr>
<tr>
<td>800,000</td>
<td>-</td>
<td>7,143</td>
<td>-</td>
</tr>
<tr>
<td>850,000</td>
<td>-</td>
<td>5,714</td>
<td>-</td>
</tr>
<tr>
<td>900,000</td>
<td>-</td>
<td>4,286</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(17,143)</td>
<td>(17,143)</td>
<td>(9,524)</td>
</tr>
</tbody>
</table>

For a possible outcome of $800,000, the entity had an expected residual return of $1,191. Therefore, all amounts for each variable interest holder should be reflected as an expected residual return. This requires the equity holder’s expected loss of $5,952 to be reallocated to expected residual returns. After this adjustment, the sum of the expected losses and residual returns of the variable interest holders equals those of the entity.
Because ASC 810-10 does not provide detailed interpretative guidance on how adjustments should be made, we believe either of the two methods is acceptable. However, a reporting entity should make an accounting policy election about which method it will use and apply that method consistently for all entities.

### A.5 Reasonableness checks

There are some reasonableness checks a reporting entity should perform after calculating an entity's expected losses and expected residual returns. One reasonableness check is to ensure that the absolute value of expected losses equals expected residual returns. Because expected losses and expected residual returns are calculated based on variability from the expected outcome (or mean), the absolute values of expected losses and expected residual returns should be equal. Even when an entity's possible outcomes are allocated to its variable interest holders, the total expected losses and expected residual returns for the variable interest holders also should be equal.

Another reasonableness check is to assess whether the calculated fair value for an entity's net assets equals or closely approximates the fair value of the net assets based on quoted market prices if a marketplace exists. Similarly, when an entity's possible outcomes are allocated to each variable interest holder, the calculated fair value of each variable interest holder’s interest should equal or closely approximate the fair value of that interest based on quoted market prices if a marketplace exists.

### Illustration A-5: Reasonableness check on the fair value of an entity’s net assets

Assume an entity has one asset, which is a zero coupon bond maturing in one year. Any liabilities of the entity are variable interests such that the cash flows associated with those variable interests are excluded when estimating the possible cash flow outcomes. The fair value of the entity's net assets, exclusive of variable interests, is calculated as follows:

<table>
<thead>
<tr>
<th>Possible outcomes</th>
<th>Present value of possible outcomes</th>
<th>Probability</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,250,000</td>
<td>$1,190,476</td>
<td>20%</td>
<td>$238,095</td>
</tr>
<tr>
<td>1,375,000</td>
<td>1,309,524</td>
<td>20%</td>
<td>261,905</td>
</tr>
<tr>
<td>1,500,000</td>
<td>1,428,571</td>
<td>20%</td>
<td>285,714</td>
</tr>
<tr>
<td>1,750,000</td>
<td>1,666,667</td>
<td>20%</td>
<td>333,333</td>
</tr>
<tr>
<td>2,000,000</td>
<td>1,904,762</td>
<td>20%</td>
<td>380,952</td>
</tr>
</tbody>
</table>

Because the bond is the entity’s only asset and all other liabilities are variable interests, the fair value of the entity’s net assets (exclusive of variable interests) is the fair value of the bond. Therefore, if the fair value of the bond based on quoted market prices equals or closely approximates $1.5 million, the calculation would be deemed reasonable.

Satisfying the reasonableness checks may prove challenging. Estimating possible outcomes and probabilities that result in an expected outcome that approximates the fair value of the entity's net assets (exclusive of variable interests) likely will be an iterative process. The same is true when an entity's possible outcomes have been allocated to its variable interest holders and a reporting entity is trying to determine whether the fair value of each variable interest is reasonable.
A.6 Approaches to calculate expected losses and expected returns

The Variable Interest Model does not provide detailed guidance on how to calculate expected losses and expected residual returns. While the concept of the expected cash flow approach is to estimate a range of possible outcomes and discount those outcomes using a risk-free interest rate, CON 7 does not describe how many possible outcomes to project or which combination of cash flows and discount rates should be used to measure variability.

There is no minimum number of possible outcomes that are required to be included in a calculation of expected losses and expected residual returns. One approach is to start with a base outcome that is believed to be the most likely to occur. Multiple possible outcomes are then projected by changing assumptions used in the base outcome. Probabilities are assigned to each outcome and used to calculate the entity’s expected losses and expected residual returns.

Another approach is to use a Monte Carlo simulation. This approach is more complex and generally requires the involvement of valuation professionals or other professionals who are skilled in the preparation and interpretation of Monte Carlo simulations. This method involves a range of values for each of the primary factors that cause uncertainty or variability in an entity’s returns. Points within the ranges of each factor are randomly selected, and an outcome is calculated from the combination of the point estimates. The random selection process is repeated many times to create multiple outcome projections. A Monte Carlo simulation may result in thousands of possible outcomes.

While these two approaches have been the most prevalent in our experience, there may be other approaches that are acceptable. Regardless of the approach selected, the outcomes used in the calculation must be based on reasonable judgments and assumptions, and the results of the calculation must satisfy the reasonableness checks described in Section A.5.

We believe that consideration of the uncertainty in the timing and amount of the entity’s cash flows is an essential element of the calculation of expected losses and expected residual returns. Said differently, while the compensation for bearing the risk of cash flow uncertainty may not be included in the analysis, the uncertainty itself should be captured because it is fundamental to determining a variable interest entity’s expected losses or expected residual returns under ASC 810-10. Paragraphs 42 through 61 of CON 7\(^1\) discuss two methodologies for incorporating cash flow uncertainty into a fair value measurement. The risk associated with cash flow uncertainty can be included in the discount rate (as described in the traditional approach) or in the cash flows of an expected cash flow approach.

Since an expected loss and expected residual return analysis under the Variable Interest Model is predicated on identifying discrete possible outcomes to assess variability, we do not believe the traditional approach is appropriate for this analysis. Instead, we believe that the use of a risk-free interest rate is appropriate under the Variable Interest Model because, ideally, all of the cash flow uncertainty associated with the entity should be captured in the expectations of the cash flows and not the discount rate. The analysis should incorporate enough possible outcomes to describe the full probability distribution of outcomes. While determining the appropriate number of possible outcomes is based on professional judgment, we believe that an analysis that considers a limited number of possible outcomes (e.g., worst case, base case, best case) will, in many situations, be insufficient to capture the variability in the expected cash flows. Determining the probability distribution of possible outcomes also is critical to this analysis and can have a significant effect on the determination of expected losses and expected residual returns.

\(^1\) A similar discussion can be found in ASC 820-10-55-4 through 55-20.
Generally, the more complex an entity's assets are and the more assets it has, the greater the number of possible outcomes that will be required. Determining when a sufficient number of possible outcomes have been included in a calculation will depend on the facts and circumstances and will require the exercise of professional judgment.

A reporting entity should consider whether all significant factors that drive variability in the entity's returns have been included in the distribution of possible outcomes. Also, if possible outcomes of the entity must be allocated to the entity's variable interest holders, it should consider whether all of the relationships between the entity's variable interest holders have been identified, including how those relationships might affect the allocation of the entity's returns.

**Question A.2**

If an entity has an indeterminate life and plans to continue operating for the foreseeable future, how should a reporting entity calculate expected losses and expected residual returns? In other words, should a reporting entity project possible cash flow outcomes over an indefinite period for the entity?

Generally, a reporting entity should calculate expected losses and residual returns by projecting possible cash flow outcomes over the anticipated life of the entity. Valuation techniques such as applying an assumed terminal value multiple to the last year of projected cash flows may be used when preparing the distribution of possible cash flow outcomes for an entity with an indeterminate life. The terminal values will vary among the possible cash flow outcomes based on the different assumptions made in projecting each possible outcome.

**A.6.1 Fair value, cash flow and cash flow prime methods**

The Variable Interest Model does not provide detailed guidance about which combination of cash flows and discount rates should be used to measure variability.

We are aware of three primary methods used to measure variability, which we refer to as the fair value, cash flow and cash flow prime methods. The method a reporting entity selects to measure variability should ensure that the variability associated with the entity's designed risks are appropriately measured and allocated to the entity's variable interest holders. The fair value method is used to compute expected losses and expected residual returns for entities designed to create fair value risk. Either the cash flow method or the cash flow prime method is used to compute expected losses and expected residual returns for entities designed to create cash flow risk.

While these methods use different combinations of cash flows and discount rates to measure variability, we believe the probabilities assigned to the possible outcomes should be consistent among the three methods.

**A.6.1.1 Fair value method**

The fair value method emphasizes fair value variability in determining whether an interest is a variable interest. In making this determination, a reporting entity considers only whether the interest absorbs variability in the fair value of an entity's net assets (exclusive of variable interests). This view was developed based on how the Variable Interest Model defines expected losses and expected residual returns (i.e., the expected variability in the fair value of an entity's net assets, exclusive of the effects of variable interests).

The fair value method projects possible cash flow outcomes under different interest rate environments. Those possible outcomes are discounted to present value using the same yield curve that was used to derive the cash flows. This results in variability (or expected losses and expected residual returns) for fixed-rate instruments but not for variable-rate instruments.
Illustration A-6:  Fair value method

Assume a fixed rate US government obligation has a par value of $1,000, a 5% coupon and matures in one year. Its cash flows are fixed at $1,050. The fair value method discounts this fixed cash flow by various rates that reflect the potential for changes in the yield curve. The different discount rates give rise to variability in the fair value of the instrument, resulting in expected losses and expected residual returns. For example, if the discount rate in one scenario is assumed to be 2%, the present value of that cash flow is $1,029 ($1,050/1.02), which gives rise to an expected residual return because $1,029 is greater than $1,000. If the discount rate in another scenario is assumed to be 7%, the present value of that cash flow is $981 ($1,050/1.07), which gives rise to an expected loss.

For a variable rate US government obligation, the fair value method produces no expected losses or expected residual returns because the rate used to project the cash flow is the same rate used to discount that cash flow.

A.6.1.2  Cash flow method

The cash flow method uses the same projected cash flows as the fair value method. That is, under the cash flow method, a reporting entity computes an entity’s expected losses and expected residual returns by projecting possible cash flow outcomes under different interest rate environments and assigning each possible outcome a probability weight. However, the cash flow method uses a different discount rate. Under this method, all possible outcomes are discounted to present value using the forward yield curve that exists at the time of the evaluation.

This method results in expected losses and expected residual returns for variable-rate instruments because the cash flows vary by scenario but are discounted using one forward yield curve. However, this method does not result in expected losses and expected residual returns for fixed-rate instruments because the cash flows do not vary. They are fixed and there is no credit risk assumed.

The only difference between the fair value method and cash flow method is the yield curve used to discount possible cash flow outcomes. The cash flow method uses only the yield curve at the evaluation date. There are no differences in the projected cash flows used under these methods.

A.6.1.3  Cash flow prime method

The cash flow prime method uses different cash flow outcomes from the fair value and cash flow methods. The fair value and cash flow methods project multiple possible cash flow outcomes under different interest rate environments while the cash flow prime method projects cash flows using only one interest rate environment (i.e., the yield curve that is also used to discount the cash flows).

Because the cash flows are projected and discounted using the same yield curve, the cash flow prime method assumes variability arising from periodic interest receipts or payments should be excluded from the calculation of expected losses and expected residual returns. That is, unlike the cash flow method, in which numerous cash flow outcomes are projected under varying interest rate environments and then discounted using a static yield curve, the cash flow prime method projects periodic interest cash flows from variable rate instruments and discounts those cash flows at the same, static interest rate curve. Mathematically, this results in no variability from periodic interest receipts or payments for variable-rate instruments due to interest rate risk.
We generally expect the cash flow prime method to be used when a reporting entity is required to calculate expected losses and expected residual returns because:

- The fair value and cash flow methods measure interest rate variability arising from periodic interest payments, and the design of many entities is not intended to create and distribute interest rate risk. Interest rate risk is typically hedged through the use of interest rate swaps or other agreements (see Chapter 5).

- The most practical way to measure variability for entities that are businesses or primarily hold or operate real estate or nonfinancial assets is based on variability in cash flow. Section A.8 includes an example of the cash flow prime method for an entity holding real estate.

The following table compares the three methods:

<table>
<thead>
<tr>
<th></th>
<th>Fair value</th>
<th>Cash flow</th>
<th>Cash flow prime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed rate US obligation</td>
<td>Cash flows are fixed. Discount rate varies by scenario. Expected losses and expected residual returns occur because fair value of cash flow varies.</td>
<td>Cash flows are fixed. Discounted using one yield curve. No expected losses and expected residual returns because cash flows are fixed.</td>
<td>Cash flows are fixed. Discounted using one yield curve. No expected losses and expected residual returns because cash flows are fixed.</td>
</tr>
<tr>
<td>Variable rate US government obligation</td>
<td>Cash flows are projected based on a forward yield curve and discounted using the same yield curve. No expected losses and expected residual returns.</td>
<td>Cash flows vary by scenario but are discounted using one yield curve, giving rise to expected losses and expected residual returns.</td>
<td>Cash flows are projected based on a forward yield curve and discounted using the same yield curve. No expected losses and expected residual returns.</td>
</tr>
</tbody>
</table>

A reporting entity should select only one method to calculate an entity's expected losses and expected residual returns. However, a reporting entity may use different methods to calculate the expected losses and expected residual returns of different entities with which it is involved, depending on the design of the entity. That is, the selection of a method to compute expected losses and expected residual returns is not a reporting entity-wide accounting policy election that must be followed consistently for all entities with which the reporting entity is involved.

**Question A.3** Should changes in market interest rates be included in estimates of possible cash flow outcomes?

Pursuant to ASC 810-10-25-33, variability arising from periodic interest receipts or payments should be excluded from the calculation of expected losses and expected residual returns if the entity was not designed to create and distribute interest rate risk. We believe that determining whether an entity was designed to create and pass on variability from periodic interest receipts or payments requires careful consideration of the specific facts and circumstances of the entity’s design.

ASC 810-10-25-33 states that a strong indicator that an entity was designed to create and pass on variability from periodic interest receipts or payments to its interest holders is that fixed-rate investments are expected to be sold before their maturity to satisfy the obligations of the entity. In these circumstances, variability in cash proceeds due to interest rate risk generally should be included in estimating possible outcomes for these investments. That is, various interest rate environments should be assumed in developing the cash flows to be received upon sale of an entity’s fixed-rate investments.
Question A.4 How should the risk that a variable interest holder may not perform according to its contractual arrangement be incorporated into an expected loss calculation (i.e., credit risk)?

The allocation of an entity’s expected losses is based on the contractual arrangements between the variable interest holders. For example, if an asset declines in value, a guarantor may be called upon to make a payment that protects other variable interest holders from absorbing the loss.

If a contractual agreement requires one variable interest holder to make a payment to either the entity or other variable interest holders in the entity upon the occurrence of certain losses, that contractual arrangement should be incorporated into the allocation of the entity’s expected losses. The risk that the variable interest holder may not perform on its obligation also should be incorporated into the calculation. This is done by multiplying the expected losses allocated to that variable interest holder by a probability of default. The probability of default should be based on reasonable judgment.

<table>
<thead>
<tr>
<th>Illustration A-7: Inclusion of credit risk in an expected losses calculation</th>
</tr>
</thead>
</table>
| An entity acquires Asset A for use in its operations. The fair value of Asset A is $300. The total fair value of the entity’s assets is $500. The entity finances the cost of Asset A entirely with debt from Lender A on a nonrecourse basis (i.e., the lender has access only to the cash flows generated by Asset A and does not have access to the general credit of the entity). In connection with the financing, Lender A requires the entity to obtain a guarantee from Guarantor A that requires Guarantor A to make a payment for the amount by which the value of Asset A decreases below $200.

The expected losses of the entity are $100. The expected losses of Asset A are $60. Of this amount, further assume $40 is related to possible outcomes of the entity in which the value of Asset A decreases to amounts below $200. It is estimated that there is a 5% chance that Guarantor A will not perform on the guarantee if Asset A’s value decreases below $200.

Analysis

The expected losses relating to Asset A would be allocated to the variable interest holders as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lender A</td>
<td>$ 22</td>
</tr>
<tr>
<td>Guarantor A</td>
<td>$ 38</td>
</tr>
<tr>
<td>Total</td>
<td>$ 60</td>
</tr>
</tbody>
</table>

Because the loan by Lender A was made on a nonrecourse basis, it will absorb all expected losses related to any decreases in the value of Asset A from $300 to $200, or the total expected losses of $60 less the expected losses of $40 attributable to possible outcomes in which the value of Asset A decreases to amounts less than $200. Additionally, there is a 5% chance that Guarantor A will not perform on the guarantee. In such instances, the expected losses relating to decreases in Asset A’s value below $200 will be absorbed by Lender A. Therefore, an additional $2 of expected losses (5% of $40) are allocated to Lender A. The remaining expected losses relating to Asset A of $38 ($60-$22) are allocated to Guarantor A.
**Question A.5**  
Should tax benefits inuring to a variable interest holder outside an entity be considered when preparing an expected loss calculation for the entity?

In certain circumstances, variable interest holders in an entity may be primarily motivated to invest in order to obtain tax benefits that occur outside the entity.

For taxable entities (e.g., corporations), after-tax cash flow outcomes should be used. For other entities (e.g., partnership), we believe that tax expense or benefit borne by or inuring to variable interest holders outside an entity generally should not be included in the cash flow outcomes used to determine whether the entity is a VIE. However, in certain circumstances, reporting entities may invest in entities primarily to obtain tax benefits that occur outside the entity and may even derive no economic benefits from the investment other than the tax benefits themselves (e.g., investments in affordable housing partnerships).

If investors in an entity have primarily acquired the right to receive tax benefits that are obtained or earned outside the entity, and those tax benefits are included in deriving the fair value of the investment, we generally believe that the tax expense or benefit borne by or inuring to variable interest holders should be included in the possible outcomes used to determine whether the entity is a VIE. We understand the SEC staff shares this view.

The following factors may indicate that an investment has been made primarily to obtain tax benefits:

- The cost of the interest is primarily a function of the tax benefits expected to be received by the investor.
- Without the tax benefits, the investor would receive a negative or substantially below market return from its investment in the entity.
- Returns on the investment may be limited because excess cash flows of the entity are distributed to other investors.
- The investor’s ability to participate in any profits from the sale of assets upon the entity’s liquidation is limited.
- The tax benefits to be received by the investor are guaranteed by other variable interest holders to provide the investor with a “targeted” rate of return on the project.

**Illustration A-8:**  
**Inclusion of investors’ tax benefits in an expected loss calculation**

Company A acquires a 99% limited partner interest in a limited partnership formed to provide affordable housing. The partnership is expected to generate housing credits and tax losses, including depreciation and interest expense, over the life of the project. These tax losses and credits will be allocated almost entirely to Company A, which anticipates that it will be able to use them in its consolidated income tax return to offset taxable income generated by its other operations and investments. Company A’s cost of acquiring the limited partner interest is based primarily on the estimated tax benefits it expects to earn.

**Analysis**

Because Company A has acquired the right to receive tax benefits, and its investment was based primarily on the anticipated receipt of those tax benefits, the tax benefits that Company A will realize should be included in the calculation of the partnership’s expected losses and expected residual returns, even though those benefits are realized outside of the partnership itself. Company A realizes the benefits by including the tax losses and credits in its consolidated income tax return. Excluding these benefits would not reflect the true variability in each variable interest holder’s returns.
A.7 Inability to obtain the information

A reporting entity may need to obtain information from third parties to calculate an entity’s expected losses and expected residual returns. If the reporting entity is unable to obtain that information, calculating expected losses and expected residual returns may be difficult. As described in Chapter 4, a reporting entity is not required to apply the provisions of the Variable Interest Model to entities created before 31 December 2003 if the reporting entity is unable to obtain information necessary to (1) determine whether the entity is a VIE, (2) determine whether the reporting entity is the VIE’s primary beneficiary or (3) perform the accounting required to consolidate the VIE. To qualify for this scope exception, the reporting entity must have made and must continue to make exhaustive efforts to obtain the information.

The FASB limited the exception to entities formed before 31 December 2003 because it believes the need for the information necessary to apply the Variable Interest Model should have been contemplated in connection with the creation of an entity formed after 31 December 2003. In addition, the exception applies only until the reporting entity obtains the necessary information, at which point the Variable Interest Model’s provisions apply. Reporting entities have a continuing obligation to attempt to obtain the necessary information to make the appropriate accounting determinations. Disclosures are required during the period the scope exception is applied.

If reporting entities are unable to obtain information needed to complete the calculation of the entity’s expected losses and expected residual returns, and the entity was formed after 31 December 2003, the reporting entity should make reasonable assumptions about the missing information and perform the calculation using those assumptions.

A.8 Example analysis of sufficiency of equity

The following example presumes a quantitative analysis of expected losses is required to determine whether the entity is a VIE. It’s important to note that often, the determination of the sufficiency of equity is qualitative. However, in certain circumstances, a reporting entity may be required to perform a quantitative analysis. This example also does not evaluate the other aspects of the Variable Interest Model (e.g., primary beneficiary determination). Therefore, certain steps have been omitted from this analysis.

Assumptions

- A limited liability company (the LLC) is formed by Manage Co. and Passive Co. to acquire and operate commercial real estate (i.e., office buildings). The LLC is to be liquidated at the end of five years.

- The interest rate on a five-year default-risk-free investment at the date of formation of the LLC is 5%.

- Manage Co. and Passive Co. make a cash equity contribution to the LLC of $6,000,000 and $4,000,000, respectively, in exchange for a 60% and 40% ownership interest in the LLC. The contributions were not financed by any other parties involved with the LLC. Each party votes on matters affecting the LLC in proportion to its ownership interest.

- The LLC acquires three buildings upon its formation, as follows:

  - Big Building is acquired for $68,700,000. This acquisition is partially financed with $63,000,000 of debt from Lender A. Lender A has recourse only to the cash flows from the lease and sale of Big Building.

  - Little Building is acquired for $29,500,000. This acquisition is partially financed with $27,000,000 of debt from Lender B. Lender B has recourse only to the cash flows from the lease and sale of Little Building.
A third building (Building Three) is acquired for $45,000,000. Lender C finances the acquisition of Building Three in its entirety. Lender C has recourse only to the cash flows from the lease and sale of Building Three.

Interest is due on each loan at a rate of 5% per year during the five-year life of the LLC, and the principal is due when the buildings are sold at the end of five years. (We have assumed that the interest rates on the loans are equal to the interest rate on a five-year default-risk-free investment to simplify the calculations.)

In connection with the debt financing, Lender A requires that the LLC acquire a guarantee from Guarantor A that the value of Big Building will not be worth less than $63,000,000 in five years for a premium of $1,300,000. Lender B requires that the LLC acquire a guarantee from Guarantor B that the value of Little Building will not be worth less than $27,000,000 in five years for a premium of $500,000.

The LLC has no employees but has engaged Manage Co. to actively manage Big Building and Little Building. In this role, Manage Co. makes decisions about the selection of tenants, negotiation of lease terms, setting of rental rates, capital expenditures, and repairs and maintenance, among other things. For these services, Manage Co. will receive fees equal to 10% of the annual net rental revenue of each building per year.

Lease terms with the tenants of Big Building and Little Building are consistent with market terms for such leases at the date of inception of the leases and do not contain fixed price purchase options, residual value guarantees or similar features.

At its acquisition date, Building Three is leased to one tenant for a five-year term. Upon expiration of the lease term, the lessee must either purchase Building Three for $45,000,000, or arrange for the sale of the building to a third party. If it elects the sale option, the Lessee will be required to pay any shortfall between the sales proceeds and $45,000,000. If the sales proceeds exceed the purchase price, the lessee is entitled to the difference.

Upon the sale of the buildings, the LLC will pay off the debt and distribute any remaining proceeds to Manage Co. and Passive Co. based on their respective ownership interests.

A scope exception to the Variable Interest Model does not apply.

The sources and uses of the LLC’s financing can be summarized as follows:

Table 1 — Sources and uses of funds

<table>
<thead>
<tr>
<th>Sources of funds</th>
<th>Uses of funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manage Co. – Equity</td>
<td>Big Building Purchase</td>
</tr>
<tr>
<td></td>
<td>$ 68,700,000</td>
</tr>
<tr>
<td>Passive Co. – Equity</td>
<td>Little Building Purchase</td>
</tr>
<tr>
<td></td>
<td>$ 29,500,000</td>
</tr>
<tr>
<td>Lender A – Loan</td>
<td>Building Three Purchase</td>
</tr>
<tr>
<td></td>
<td>$ 45,000,000</td>
</tr>
<tr>
<td>Lender B – Loan</td>
<td>Guarantee Fees</td>
</tr>
<tr>
<td></td>
<td>Big Building</td>
</tr>
<tr>
<td></td>
<td>$ 1,300,000</td>
</tr>
<tr>
<td>Lender C – Loan</td>
<td>Little Building</td>
</tr>
<tr>
<td></td>
<td>$ 500,000</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td></td>
<td><strong>$ 145,000,000</strong></td>
</tr>
</tbody>
</table>

$ 145,000,000
The fair values of the assets of the LLC are as summarized in Table 2 below. The fair value of each building is allocated to the lenders based on the principal amounts loaned to the LLC. The remaining fair value of each building and the guarantee are allocated to Manage Co. and Passive Co. in proportion to their relative ownership in the LLC (i.e., 60% to Manage Co. and 40% to Passive Co., respectively). It’s important to note that in some cases it may not be necessary to allocate the fair value of an entity’s individual assets if all variable interests are considered to be variable interests in the entity as a whole, and there are no variable interests in specified assets or silos.

### Table 2 — Fair value of the LLC’s assets

<table>
<thead>
<tr>
<th></th>
<th>Manage Co.</th>
<th>Passive Co.</th>
<th>Lender A</th>
<th>Lender B</th>
<th>Lender C</th>
<th>Total fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Big Building</td>
<td>$3,420,000</td>
<td>$2,280,000</td>
<td>$63,000,000</td>
<td>N/A</td>
<td>N/A</td>
<td>$68,700,000</td>
</tr>
<tr>
<td>Building</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guarantee</td>
<td>780,000</td>
<td>520,000</td>
<td></td>
<td></td>
<td>N/A</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Total</td>
<td>4,200,000</td>
<td>2,800,000</td>
<td>63,000,000</td>
<td></td>
<td>N/A</td>
<td>70,000,000</td>
</tr>
<tr>
<td>Little Building</td>
<td>1,500,000</td>
<td>1,000,000</td>
<td></td>
<td>N/A</td>
<td></td>
<td>29,500,000</td>
</tr>
<tr>
<td>Building</td>
<td>300,000</td>
<td>200,000</td>
<td></td>
<td></td>
<td></td>
<td>500,000</td>
</tr>
<tr>
<td>Guarantee</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1,800,000</td>
<td>1,200,000</td>
<td></td>
<td></td>
<td></td>
<td>30,000,000</td>
</tr>
<tr>
<td>Building Three</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>45,000,000</td>
</tr>
<tr>
<td>Total Amounts</td>
<td>$6,000,000</td>
<td>$4,000,000</td>
<td>$63,000,000</td>
<td>$27,000,000</td>
<td>$45,000,000</td>
<td>$145,000,000</td>
</tr>
</tbody>
</table>

In the tables presented throughout the remainder of this appendix, certain immaterial differences may arise in the summations of totals due to rounding.

**Step 1**

Before calculating expected losses and expected residual returns, a reporting entity should determine which interests are variable interests as described in Chapter 5.

**Analysis**

The following parties hold variable interests in the LLC:

1. The equity investors (Manage Co. and Passive Co.)
2. Lenders A, B and C
3. Guarantors A and B
4. Building Three Lessee

The lessees of Big Building and Little Building do not have a variable interest in the LLC because the lease terms are consistent with market terms for such leases at the date of inception of the leases and do not contain fixed price purchase options, residual value guarantees or similar features. That is, the lessees do not absorb changes in the fair value of the buildings through their operating leases. Rather, the lessees create risk to the LLC through their potential failure to perform. In contrast, the lessee of Building Three has a variable interest due to the residual value guarantee and fixed price purchase option included in the lease.

Also, the fees paid to Manage Co. represent a variable interest because the fees do not satisfy all of the conditions of ASC 810-10-55-37. Manage Co. holds other interests (i.e., 60% equity interest) that would absorb more than an insignificant amount of the LLC’s expected variability.
Step 2
Next, a reporting entity should determine whether any silos exist in the LLC as described in Chapter 6.

Analysis
Building Three represents a silo. The building has been financed in its entirety with debt that has recourse only to Building Three and its related cash flows. The lessee has provided a residual value guarantee that will absorb any depreciation in the value of the building and has a fixed price purchase option that allows it to capture any appreciation in the value of the building during the lease term. If the lessee defaults on the lease payments or the residual value guarantee, Lender C will absorb any related losses. Accordingly, essentially all of the expected losses and essentially all of the expected residual returns relating to Building Three are allocable to either the lessee or Lender C, and none of the expected losses or expected residual returns are borne by, or inure to, Manage Co. or Passive Co. as the LLC’s equity holders (or any other variable interest holders in the LLC).

Because Building Three is a silo, any expected losses and expected residual returns allocable to Building Three’s variable interest holders (i.e., the Lessee of Building Three and Lender C) are not considered in determining whether the LLC is a VIE. Accordingly, Building Three, the associated lease and the related debt will not be considered in evaluating the LLC for the remainder of this example.

It’s important to note that silos are separately evaluated for consolidation if the host entity is a VIE. Therefore, if the conclusion is that the LLC is a VIE, the variable interest holders in the silo (i.e., Lender C and the lessee of Building Three) would be required to evaluate the Building Three silo as a separate VIE to determine if either party is the silo’s primary beneficiary that should consolidate the silo.

Step 3
Determine whether any of the variable interests qualify as variable interests in specified assets of the LLC but not the LLC as a whole as described in Chapter 5.

Analysis
Lender B and Guarantor B have a variable interest in a specified asset (i.e., Little Building) but not the LLC as a whole because the fair value of Little Building does not comprise more than half of the total fair value of the LLC’s assets (after excluding the fair value of Building Three, which is a silo). Therefore, expected losses that would be absorbed by Lender B or Guarantor B should be excluded from the expected losses of the LLC when determining whether the LLC’s equity investment at risk is sufficient.

Conversely, Guarantor A and Lender A are variable interest holders in the LLC as a whole because each holds a variable interest in an asset (i.e., Big Building) that comprises more than half of the total fair value of the LLC’s assets (after excluding the fair value of Building Three, which is a silo).

Step 4
Determine whether the LLC’s equity investment at risk is sufficient by calculating the expected losses of the LLC. This calculation should exclude expected losses absorbed by the variable interests in specified assets and silos.

To compute the LLC’s expected losses and expected residual returns, a distribution of possible outcomes must be projected and discounted for the LLC. Due to the nature of the LLC’s assets in this example (i.e., only two assets with distinctly separable values and cash flow streams), the expected losses and expected residual returns are separately calculated for Big Building and Little Building. In many cases, the possible outcomes will be projected on an aggregate basis for an entity as whole.
The possible outcomes for Big Building are presented in Table 3 below.

**Table 3 — Big Building possible outcomes**

<table>
<thead>
<tr>
<th>Possible Rental Income</th>
<th>Decision Maker Fees</th>
<th>Possible Cash Flows From Sale of Building</th>
<th>Total Possible Undiscounted Outcomes</th>
<th>Present Value of Possible Outcomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>$18,000,000</td>
<td>$2,000,000</td>
<td>$55,000,000</td>
<td>$75,000,000</td>
<td>$60,411,846</td>
</tr>
<tr>
<td>$18,750,000</td>
<td>$2,083,333</td>
<td>$58,000,000</td>
<td>$83,250,000</td>
<td>$63,484,004</td>
</tr>
<tr>
<td>$19,500,000</td>
<td>$2,166,667</td>
<td>$64,200,000</td>
<td>$90,000,000</td>
<td>$69,063,445</td>
</tr>
<tr>
<td>$20,500,000</td>
<td>$2,277,778</td>
<td>$70,000,000</td>
<td>$97,200,000</td>
<td>$74,570,003</td>
</tr>
<tr>
<td>$21,250,000</td>
<td>$2,361,111</td>
<td>$71,500,000</td>
<td>$98,750,000</td>
<td>$76,662,753</td>
</tr>
<tr>
<td>$22,500,000</td>
<td>$2,500,000</td>
<td>$76,500,000</td>
<td>$101,500,000</td>
<td>$81,587,135</td>
</tr>
</tbody>
</table>

The possible outcomes for Little Building are presented in Table 4 below.

**Table 4 — Little Building possible outcomes**

<table>
<thead>
<tr>
<th>Possible Rental Income</th>
<th>Decision Maker Fees</th>
<th>Possible Cash Flows From Sale of Building</th>
<th>Interest Paid to Lender B</th>
<th>Principal Paid to Lender B</th>
<th>Fees paid to Guarantor B</th>
<th>Possible Cash Flows from Guarantee</th>
<th>Total Possible Undiscounted Outcomes</th>
<th>Present Value of Possible Outcomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>$7,000,000</td>
<td>$777,778</td>
<td>$22,000,000</td>
<td>(6,750,000)</td>
<td>(27,000,000)</td>
<td>$5,000,000</td>
<td>$1,193,333</td>
<td>$527,778</td>
<td>$389,948</td>
</tr>
<tr>
<td>8,000,000</td>
<td>888,889</td>
<td>25,000,000</td>
<td>(6,750,000)</td>
<td>(27,000,000)</td>
<td>2,000,000</td>
<td>2,333,333</td>
<td>1,638,889</td>
<td>1,352,054</td>
</tr>
<tr>
<td>8,625,000</td>
<td>958,333</td>
<td>26,000,000</td>
<td>(6,750,000)</td>
<td>(27,000,000)</td>
<td>1,000,000</td>
<td>3,722,222</td>
<td>2,333,333</td>
<td>1,953,370</td>
</tr>
<tr>
<td>9,875,000</td>
<td>1,097,222</td>
<td>27,000,000</td>
<td>(6,750,000)</td>
<td>(27,000,000)</td>
<td>2,000,000</td>
<td>6,361,111</td>
<td>3,156,003</td>
<td>5,235,081</td>
</tr>
<tr>
<td>10,000,000</td>
<td>1,111,111</td>
<td>29,500,000</td>
<td>(6,750,000)</td>
<td>(27,000,000)</td>
<td>1,000,000</td>
<td>6,361,111</td>
<td>5,235,081</td>
<td>7,674,950</td>
</tr>
<tr>
<td>10,500,000</td>
<td>1,166,677</td>
<td>32,000,000</td>
<td>(6,750,000)</td>
<td>(27,000,000)</td>
<td>500,000</td>
<td>9,416,667</td>
<td>7,674,950</td>
<td>5,235,081</td>
</tr>
</tbody>
</table>
In Tables 3 and 4, we have assumed that the possible rental income for each building is comprised of an equal amount in each of the five years the properties are rented. In reality, net rental income likely would vary in each period, and possible outcomes should reflect risks such as vacancy risk, tenant credit risk, rental rate risk and other risks. In addition, there would generally be more than six possible outcomes assumed for each building (see Section A.6).

Amounts paid to or received from Lender A and Guarantor A are not considered in determining the distribution of possible outcomes of Big Building, because these interests are variable interests in the LLC as a whole. Expected losses and expected residual returns are based on the expected variability in an LLC’s net assets, exclusive of the effects of variable interests, which serve to allocate the variability in the fair value of the LLC’s net assets.

Conversely, because Lender B and Guarantor B do not have variable interests in the LLC as a whole (see Step 3), amounts paid to and received from Lender B and Guarantor B are included in determining the distribution of possible outcomes of Little Building. These amounts represent cash outflows to and inflows from parties that are not variable interest holders in the LLC. Interest and principal payments are based on the assumed terms of the loan. The possible cash inflows from the guarantee are derived by subtracting the assumed value received upon the disposal of Little Building from the guarantee amount. For example, if $22 million is received from the sale of Little Building, the LLC would be entitled to receive $5 million from Guarantor B because the guarantee is for $27 million. This example does not include any adjustments for the risk that Guarantor B will not perform on the guarantee. In reality, that risk should be included in the possible outcomes (see Question A.4).

The fees paid to Manage Co. for acting as the decision maker are shown as an add back to net rental income because the fees represent a variable interest in the LLC and are not considered in determining the distribution of possible outcomes for Big Building and Little Building.

Once the distribution of possible outcomes for each of the buildings has been determined, each possible outcome should be probability weighted based on its estimated likelihood of occurrence, and the mean of the distribution of all possible outcomes should be calculated. The mean of the distribution of all possible outcomes should equal, or closely approximate, the fair value of the variable interests in the assets.

Table 5 demonstrates that the mean of the distribution of Big Building’s possible outcomes closely approximates (within 1%) the sum of the fair value of the variable interests in the asset.
Table 5 - Mean of distribution of possible outcomes closely approximates fair value of variable interests in Big Building

<table>
<thead>
<tr>
<th>Present Value of Possible Outcomes</th>
<th>Estimated Probability of Outcomes</th>
<th>Proof of Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$60,411,846</td>
<td>10%</td>
<td>$6,041,185</td>
</tr>
<tr>
<td>63,484,004</td>
<td>18%</td>
<td>11,427,121</td>
</tr>
<tr>
<td>69,063,445</td>
<td>25%</td>
<td>17,265,861</td>
</tr>
<tr>
<td>74,570,003</td>
<td>25%</td>
<td>18,642,501</td>
</tr>
<tr>
<td>76,662,753</td>
<td>15%</td>
<td>11,499,413</td>
</tr>
<tr>
<td>81,587,135</td>
<td>7%</td>
<td>5,711,099</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td>$70,587,180</td>
</tr>
</tbody>
</table>

Table 6 demonstrates that the mean of the distribution of Little Building's possible outcomes also closely approximates (within 1%) the sum of the fair value of the variable interests in the asset.
Table 6 – Mean of distribution of possible outcomes closely approximates fair value of variable interests in Little Building

<table>
<thead>
<tr>
<th>Present Value of Possible Outcomes</th>
<th>Estimated Probability of Outcomes</th>
<th>Proof of Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Little Building</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$ 389,948</td>
<td>5%</td>
<td>$ 19,497</td>
</tr>
<tr>
<td>1,352,054</td>
<td>10%</td>
<td>135,205</td>
</tr>
<tr>
<td>1,953,370</td>
<td>25%</td>
<td>488,343</td>
</tr>
<tr>
<td>3,156,003</td>
<td>30%</td>
<td>946,801</td>
</tr>
<tr>
<td>5,235,081</td>
<td>20%</td>
<td>1,047,016</td>
</tr>
<tr>
<td>7,674,950</td>
<td>10%</td>
<td>767,495</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td>$ 3,404,357</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variable Interests in Little Building</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Manage Co.</td>
<td>$ 1,500,000</td>
</tr>
<tr>
<td>Passive Co.</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Decision Maker fees</td>
<td>896,562</td>
</tr>
<tr>
<td>$ 3,396,562</td>
<td></td>
</tr>
</tbody>
</table>

Fair values of variable interests held by Manage Co. and Passive Co. are from Table 2 above.

Ensuring that the mean of the distribution of the possible outcomes equals, or closely approximates, fair value of the variable interests is one of the reasonableness checks for an expected losses and expected residual returns calculation (see Section A.5). Satisfying this reasonableness check may prove challenging and may require the use of trial and error relating to the projection of possible outcomes and the probability weights assigned to each possible outcome.

Once the distribution of possible outcomes has been determined and probability weighted, and the mean of the distribution equals or closely approximates the fair value of the variable interests under evaluation, expected losses and expected residual returns can be computed, as demonstrated in Table 7.
Table 7 – Calculation of the LLC’s expected losses and expected residual returns

See Tables 3 and 4 above for the computation of the present value of the possible outcomes of each building.

Fair values for each building represent the mean of the buildings’ distributions of possible outcomes. The computation of each amount is demonstrated in Tables 5 and 6.

Probabilities are the same for each building as demonstrated above in Tables 5 and 6. Once probabilities are assigned to possible outcomes, these should be held constant throughout the computation.

<table>
<thead>
<tr>
<th>Present Value of Possible Outcomes</th>
<th>Fair Value Difference</th>
<th>Estimated Probability of Outcomes</th>
<th>Expected Losses</th>
<th>Expected Residual Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Big Building</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>60,411,846</td>
<td>70,587,180</td>
<td>(10,175,334)</td>
<td>10%</td>
<td>(1,017,533)</td>
</tr>
<tr>
<td>63,484,004</td>
<td>70,587,180</td>
<td>(7,103,176)</td>
<td>18%</td>
<td>(1,278,572)</td>
</tr>
<tr>
<td>69,063,445</td>
<td>70,587,180</td>
<td>(1,523,734)</td>
<td>25%</td>
<td>(380,934)</td>
</tr>
<tr>
<td>74,570,003</td>
<td>70,587,180</td>
<td>3,982,823</td>
<td>25%</td>
<td>$	ext{—}$</td>
</tr>
<tr>
<td>76,662,753</td>
<td>70,587,180</td>
<td>6,075,574</td>
<td>15%</td>
<td>$	ext{—}$</td>
</tr>
<tr>
<td>81,587,135</td>
<td>70,587,180</td>
<td>10,099,955</td>
<td>7%</td>
<td>$	ext{—}$</td>
</tr>
<tr>
<td><strong>Little Building</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>389,948</td>
<td>3,404,357</td>
<td>(3,014,409)</td>
<td>5%</td>
<td>(150,720)</td>
</tr>
<tr>
<td>1,352,054</td>
<td>3,404,357</td>
<td>(2,052,303)</td>
<td>10%</td>
<td>(205,230)</td>
</tr>
<tr>
<td>1,955,370</td>
<td>3,404,357</td>
<td>(1,450,987)</td>
<td>25%</td>
<td>(362,747)</td>
</tr>
<tr>
<td>3,156,003</td>
<td>3,404,357</td>
<td>(248,355)</td>
<td>30%</td>
<td>(74,506)</td>
</tr>
<tr>
<td>5,235,081</td>
<td>3,404,357</td>
<td>1,830,724</td>
<td>20%</td>
<td>$	ext{—}$</td>
</tr>
<tr>
<td>7,674,950</td>
<td>3,404,357</td>
<td>4,270,582</td>
<td>10%</td>
<td>$	ext{—}$</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| **Expected losses and expected residual returns** | \( (3,470,243) \) | \( 3,470,243 \) | \( 3,470,243 \)

Expected losses and expected residual returns are computed by subtracting the fair value of the variable interests in the buildings from the present value of each possible outcome and multiplying the difference by the probability associated with the possible outcome. To illustrate, the Big Building expected loss of $(1,017,533)$ for the first possible outcome is computed as the possible outcome’s present value of $60,411,846, less the fair value of the variable interests of $70,587,180 (a difference of $10,175,334) multiplied by the associated probability of 10%. The absolute value of expected losses equals expected residual returns. This is also one of the reasonableness checks that a calculation of expected losses and expected residual returns must satisfy (see Section A.5).
Step 5
Determine whether the LLC’s equity investment at risk is sufficient to absorb its expected losses (excluding expected losses attributable to silos and variable interests in specified assets)

Analysis
To determine whether the LLC’s equity investment at risk is sufficient, the LLC’s equity instruments first must be identified and the fair value of the instruments determined. Once identified, the characteristics of the equity instruments must be assessed to ensure that each is an equity investment at risk.

In this example, the LLC’s equity investments are comprised of the amounts contributed by Manage Co. and Passive Co. There are no features to the investments that suggest that they would not be reported as equity in the LLC’s GAAP balance sheet (e.g., they are not mandatorily redeemable except upon the planned liquidation of the LLC). Because the analysis is being performed at inception of the LLC, the fair value of the interests is equal to the amounts contributed.

The equity investments made by Manage Co. and Passive Co. are deemed to be at risk, based on the following analysis.

- The equity investments participate significantly in the profits and losses of the LLC. The protection provided by the guarantee of the residual value of Big Building provides protection to Lender A only if the value of Big Building declines to an amount that reduces the equity investment at risk in Big Building to zero.

- The equity interests were not issued in exchange for subordinated interests in other VIEs.

- The equity investments were not provided to Manage Co. or Passive Co. directly or indirectly by the LLC or by other parties involved with the LLC.

- The equity investments were not financed for Manage Co. or Passive Co. by the LLC or by other parties involved with the LLC.

Accordingly, the LLC is deemed to have an equity investment at risk equal to the combined investments of Manage Co. and Passive Co., or $10,000,000. This amount is compared with the LLC’s expected losses to determine whether the equity investment at risk is sufficient. Because the $10,000,000 equity investment at risk exceeds the LLC’s expected losses of $3,470,243 (the sum of expected losses associated with Big Building and Little Building), the LLC is not a VIE. (This example assumes the other VIE criteria are not met.)
B Affordable housing projects

B.1 Summary of the tax credit

Excerpt from Accounting Standards Codification

Investments – Equity Method and Joint Ventures – Income Taxes

Overview and background

323-740-05-02

The Qualified Affordable Housing Project Investments Subsections provide income tax accounting guidance on a specific type of investment in real estate. This guidance applies to investments in limited liability entities that manage or invest in qualified affordable housing projects and are flow-through entities for tax purposes.

323-740-05-03

The following discussion refers to and describes a provision within the Revenue Reconciliation Act of 1993; however, it shall not be considered a definitive interpretation of any provision of the Act for any purpose. The Revenue Reconciliation Act of 1993, enacted in August 1993, retroactively extended and made permanent the affordable housing credit. Investors in entities that manage or invest in qualified affordable housing projects receive tax benefits in the form of tax deductions from operating losses and tax credits. The tax credits are allowable on the tax return each year over a 10-year period as a result of renting a sufficient number of units to qualifying tenants and are subject to restrictions on gross rentals paid by those tenants. These credits are subject to recapture over a 15-year period starting with the first year tax credits are earned. Corporate investors generally purchase an interest in a limited liability entity that manages or invests in the qualified affordable housing projects.

B.2 Summary of the investment

Affordable housing projects usually are established as limited partnerships that pass the tax benefits directly to the investors. A general partner builds or renovates the housing project, issues the partnership interests, and maintains and operates the project. The general partner typically holds a very small percentage of the equity investment in the partnership (the general partnership interest can be as little as 0.01%), and the limited partners hold the remaining interests.

In one common arrangement, the investors acquire a direct limited partnership interest in each housing project. More complex arrangements may be used, which include the use of two or three tiers of limited partnerships. In this form, the investors contribute capital to the upper-tier partnership (Investment Partnership) as limited partners. The Investment Partnership, in turn, invests as a limited partner in one or more lower-tier partnerships (Operating Partnerships) that own housing projects. The general partner of the Investment Partnership may serve as a co-general partner in each Operating Partnership to exercise certain decision-making rights on behalf of the Investment Partnership. In a typical structure, the general partner cannot liquidate the partnership without the consent of the limited partners. Additionally, the limited partners may or may not have the ability to remove the general partner without cause.

Limited partners often are individuals or entities that are able to utilize the tax benefits and, in most cases, derive no economic benefit from the investment other than the tax benefits. In other cases, in addition to the return on investment from the tax credits and tax benefits (which are obtained because the limited partners are allocated operating losses from the partnership that are deductible), the eventual disposition of the property is expected to provide a modest amount of proceeds to the limited partners.
The price paid to acquire an interest in the project is primarily a function of the estimated tax benefits to be earned. It is anticipated that the partnership will generate housing credits and tax losses, including depreciation and interest expense, over the life of the project, which will be allocated proportionately to the partners. In addition, most of these partnerships are designed to allocate any excess cash flow of the partnership to the general partners, except for excess cash flow generated on the sale of the property. Cash flows from the sale of property, which are generally not expected to be significant, may be allocated partially to the limited partners. In summary, the limited partners receive their investment return through tax credits and tax benefits from allocated losses of the partnership. They also may receive a modest amount of proceeds from the eventual disposition of the property.

The general partner (or in some cases, a related party of the general partner) may make certain guarantees to the limited partners, which could include:

- **Construction guaranty** – The general partner guarantees that it will fund any amounts necessary to complete the project’s construction if the partnership does not have sufficient funds to do so.

- **Guaranty against operating deficits** – The general partner guarantees that it will advance partnership funds, typically structured as loans, to pay any operating deficits of the partnership for a period of years (commonly three to five years).

- **Guaranty against reduction of credit amount** – The general partner guarantees that, if the amount of the actual tax credits allocated to investors is less than the projected tax credits, the general partner will pay to the partnership for distribution to the limited partners an amount equal to the credit adjustment grossed up by any resulting tax liability of the limited partner.

**VIE considerations**

Limited partners may have protective rights with respect to an affordable housing partnership’s significant activities, but they usually do not have the ability to make decisions about these activities. Additionally, limited partners typically do not have the ability to remove the general partner without cause. Because the general partner typically makes the significant decisions and the limited partners typically do not have substantive kick-out rights or participating rights, an affordable housing partnership with the terms described above will be a VIE (see Chapter 7 for guidance on determining whether a limited partnership is a VIE).

Furthermore, when the general partner provides one or more of the guarantees described above, the partnership may be a VIE if the guarantee(s) protect the at-risk equity investors (i.e., the limited partners) from the first dollar risk of loss. Thus, the at-risk equity investors do not have the obligation to absorb the expected losses of the entity (see ASC 810-10-15-14(b)(2) and Section 7.3.2).

The affordable housing partnership also should be evaluated under the anti-abuse test to determine whether it is a VIE (see Section 7.4). If the limited partner has up to 99.99% of the affordable housing partnership’s economics and no significant voting rights, it initially may appear that substantially all of the entity’s activities are conducted on behalf of the limited partner (i.e., because it has up to a 99.99% investment in the partnership) resulting in the partnership being a VIE. However, we do not believe the size of the investment alone is determinative in assessing whether substantially all of the entity’s activities are conducted on behalf of the investor with disproportionately few voting rights. Instead, we believe the nature of the activities being performed by the entity should be compared with the activities performed by the investor as part of its ongoing operations to make this determination. In this case, because the partnership provides affordable housing, and in typical affordable housing partnerships, the limited partners generally are not engaged in that same activity, we do not believe that substantially all of the entity’s activities are conducted on behalf of the limited partner. Conversely, if the limited partner is engaged in developing or providing housing, its activities would be similar to that of the entity, and the entity generally would be considered a VIE pursuant to the Variable Interest Model’s anti-abuse clause.
In evaluating whether the affordable housing partnership has sufficient equity in accordance with ASC 810-10-15-14(a), we believe that the tax benefits provided to the limited partners should be included in the evaluation of the partnership's expected losses and expected residual returns (see Question A.5).

The accounting analysis above is of a typical affordable housing partnership. The terms of each entity should be evaluated carefully against the Variable Interest Model's VIE criteria before making that determination.

**B.3 Primary beneficiary considerations**

A reporting entity with a variable interest in a VIE is required to consolidate that VIE if it has both power and benefits (see Chapter 8 for additional discussion). As discussed above, typically the general partner has the power to direct the most significant activities of the entity. The general partner typically also receives operating fees. When determining whether the general partner has benefits, it will exclude fee arrangements that are customary and commensurate. However, fee arrangements that expose the general partner to risk of loss (e.g., for providing a guarantee) must be considered in the benefits analysis. Therefore, the terms of each entity should be evaluated carefully against the Variable Interest Model's primary beneficiary provisions when determining if the general partner has benefits.

As discussed in Chapter 9, if a general partner concludes that it (1) individually does not satisfy the characteristics of a primary beneficiary and (2) is not under common control with one or more entities that, as a group, have the characteristics of a primary beneficiary, it will still need to determine whether:

- The general partner and one or more limited partners are related parties or de facto agents and, as a group, they have the characteristics of a primary beneficiary, and, if so
- Substantially all of the activities of the entity are conducted on behalf of a single limited partner that is a related party or de facto agent of the decision maker.

However, the primary beneficiary provisions of the Variable Interest Model specifically exempts limited partners in low income housing tax credit partnerships from having to assess whether they benefit from “substantially all” of the entity’s activities. As noted in paragraph 72 of the Basis for Conclusions to ASU 2015-02, the FASB was concerned that investors would be required to consolidate these partnerships despite not meeting the power test when they hold “substantially all” of the limited partner interests, which would have undermined the objective of ASU 2014-01.

**Illustration B-1 — Determining the primary beneficiary of an affordable housing project**

A general partner creates a low income housing tax credit partnership that is determined to be a VIE. An unrelated party, Entity A, holds 99% of the equity interests and the general partner holds the remaining 1% equity interest. Both investments are considered equity at risk. The general partner makes all decisions through its equity interest. The limited partner is considered a de facto agent of the general partner (and therefore a related party under the Variable Interest Model) because the limited partner is restricted from selling its investment in the VIE without the approval of the general partner, but they are not under common control. The general partner concluded it does not have benefits that potentially could be significant to the VIE.

**Analysis**

The related party group has power through the rights held by the general partner through its equity interest, and benefits through the limited partner investment. However, it is likely that no entity in the group would consolidate the VIE because the limited partner is exempt from evaluating whether substantially all the activities of the VIE are conducted on its behalf.
C Voting Model and consolidation of entities controlled by contract

C.1 Introduction

Excerpt from Accounting Standards Codification
Consolidation — Overall
Scope and Scope Exceptions — General
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 it should first apply the guidance in those Subsections. Paragraph 810-10-15-17 provides specific exceptions to applying the guidance in the Variable Interest Entities Subsections.

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

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

The purpose of consolidated financial statements is to present 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. The first step in determining whether a reporting entity has a controlling financial interest in an entity is to establish whether consolidation should be evaluated based on ownership of the entity’s outstanding voting interests or the entity’s variable interests.

The guidance for evaluating control generally is contained within ASC 810, but certain entities are excluded from ASC 810’s scope. See Section 4.3 for a discussion of the scope of ASC 810. For entities in the scope of ASC 810, the Variable Interest Model should be applied first to determine whether the entity is a VIE. If the entity is a VIE, consolidation is based on the entity’s variable interests and not its outstanding voting shares. If the entity is not in the scope of the Variable Interest Model or is not a VIE, the consolidation guidance for voting interest entities (i.e., the Voting Model) should be applied.

---

1 ASC 810-10 includes guidance on consolidation considerations for voting interest entities and VIEs for each of the ASC 810-10 sections. Each of these sections has a General subsection on the consolidation model. This guidance applies to voting interest entities and also may apply to variable interest entities in certain circumstances. The Variable Interest Entities subsection within each of the ASC 810-10 sections contains considerations for VIEs. In referring to the Variable Interest Model, we are referring to the guidance applicable to VIEs in each of ASC 810-10 sections.
The Voting Model has separate guidance for evaluating whether to consolidate corporations and similar entities and whether to consolidate limited partnerships and similar entities (e.g., some limited liability companies). We discuss this guidance in Section C.2.1 and C.2.2, respectively. Judgment may be required to determine whether an entity is more akin to a corporation or to a partnership. See Section 7.3.1.6 for additional guidance on making this determination.

Entities that are not VIEs or that are not identified as exceptions to the basic consolidation criteria may be controlled by contract under ASC 810. However, we believe application of this guidance is limited because entities controlled by contract are often VIEs. See Section C.4 for an overview of the guidance for the consolidation of entities controlled by contract.

See the chart in Section 1.1.2, which summarizes how to apply ASC 810’s consolidation accounting guidance.

C.1.1 SEC regulations on consolidation

The consolidation requirement applies to any entity that is controlled through voting rights or their equivalent (e.g., one party can unilaterally make major decisions), even if the investee is unincorporated or has no common stock outstanding. The legal form of an entity does not determine whether it should be consolidated – controlled entities must be consolidated, regardless of their legal form. Rule 1-02(g) of Regulation S-X states that for SEC registrants the term “control” means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract or otherwise. Rule 3A-02(a) of Regulation S-X further provides that, generally, registrants should consolidate entities that are majority owned and should not consolidate entities that are not majority owned. The determination of majority ownership can require a careful analysis of the facts and circumstances.

C.1.2 Scope of the voting interest entity model

Excerpt from Accounting Standards Codification

Consolidation – Overall

Scope and Scope Exceptions – General

810-10-15-5

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.

810-10-15-6

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

810-10-15-10

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:

a. 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...

2. A majority-owned subsidiary in which a parent has a controlling financial interest shall not be consolidated if the parent is a broker-dealer within the scope of Topic 940 and control is likely to be temporary.


c. Subtopic 810-30 shall be applied to determine the consolidation status of a research and development arrangement.

d. The Consolidation of Entities Controlled by Contract Subsections of this Subtopic shall be applied to determine whether a contractual management relationship represents a controlling financial interest.

e. Paragraph 710-10-45-1 addresses the circumstances in which the accounts of a rabbi trust that is not a VIE (see the Variable Interest Entities Subsections for guidance on VIEs) shall be consolidated with the accounts of the employer in the financial statements of the employer.

There are four scope exceptions to the consolidation guidance in ASC 810: (1) employee benefit plans, (2) certain investment companies (3) governmental organizations and (4) money market funds that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the 1940 Act. See Section 4.3 for further discussion of these exceptions.

We believe that it is inappropriate to analogize to the scope exceptions. That is, unless a specific scope exception exists, an entity is subject to all of the provisions of the consolidation guidance.

The Voting Model guidance applies to reporting entities required to apply the consolidation guidance in the General Subsections of ASC 810, including not-for-profit entities, except in the following circumstances:

> When the reporting entity is a broker-dealer in the scope of ASC 940 and control is temporary
> When the reporting entity is an investment company, which would not consolidate a non-investment-company investee (except as discussed in ASC 946-810-45-3 and in Appendix F)
> When the reporting entity is involved in a research and development arrangement, as discussed in ASC 810-30
> When an entity is a Rabbi trust that is not a VIE, as discussed in ASC 710-10-45-1

Not-for-profit entities also are subject to the guidance in Subtopic 958-810.

C.2 Voting Model: Controlling financial interests

The usual condition for a controlling financial interest is ownership of a majority voting interest of a corporation or a majority of kick-out rights for a limited partnership.

C.2.1 Voting Model: Consolidation of corporations

Excerpt from Accounting Standards Codification

Consolidation — Overall

Scope and Scope Exceptions — General

810-10-15-8

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.
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.

**Recognition**

810-10-25-1

For legal entities other than limited partnerships, consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest is ownership of a majority voting interest, but in some circumstances control does not rest with the majority owner.

Consolidation generally is required when a reporting entity, directly or indirectly, has a controlling financial interest in another entity. For voting interest entities that are corporations, (i.e., entities that are not VIEs), the usual condition for a controlling financial interest is ownership of a majority of the voting interest, and, therefore, as a general rule, ownership by one reporting entity, directly or indirectly, of more than 50% of the outstanding voting shares of another entity points toward consolidation. All majority-owned subsidiaries — all entities in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest — should be consolidated, unless control does not rest with the majority owner. See Section C.3 for further discussion of conditions when control does not rest with the majority owner.

**C2.1.1 Consolidation of a not-for-profit organization other than a partnership**

As discussed in Section 4.4.1, as long as a reporting entity is not using a not-for-profit organization to circumvent the Variable Interest Model, the not-for-profit organization is evaluated for consolidation under the Voting Model or the Entities Controlled by Contract subsections of ASC 810.

Under the Voting Model, as discussed in ASC 810-10-15-8, a reporting entity that serves as the sole corporate member or controls the board of directors of a not-for-profit organization that is not a limited partnership generally would consolidate a not-for-profit organization absent the presence of substantive kick-out rights or participating rights held by a third party or parties, because it is considered to have a controlling financial interest. However, the reporting entity should carefully consider any local laws or regulations that might affect this conclusion.

**C.2.2 Voting Model: Control of limited partnerships and similar entities**

**Excerpt from Accounting Standards Codification**

Consolidation – Overall

Glossary

810-10-20

Kick-Out Rights (Voting interest entity definition)

The rights underlying the limited partner’s or partners’ ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.
Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation. Consolidation is appropriate if a reporting entity has a controlling financial interest in a limited partnership and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest in a limited partnership is ownership of a majority of the limited partnership’s kick-out rights through voting interests, but, in some circumstances, control does not rest with the majority owner.

As discussed in Section 7.3.1.3.2, for a limited partnership to be a voting interest entity (and not a VIE) either of the following criteria must be met:

- A single limited partner, partners with a simple majority of voting interests or partners with a smaller voting interest with equity at risk are able to exercise substantive kick-out rights.
- Limited partners with equity at risk are able to exercise substantive participating rights.

The presence of such rights indicates that the entity is structured with substantive voting rights. In limited partnerships, kick-out rights are analogous to voting rights held by shareholders of a corporation because these rights enable the limited partner(s) to remove the general partner without cause, thereby allowing the limited partners with kick-out rights to make the decisions about the activities that most significantly affect the limited partnership’s economic performance. Therefore, a limited partner that holds a majority of the kick-out rights would consolidate a voting interest entity.

The ability to kick out the general partner often results from a combination of the magnitude of the voting interests held by the limited partner(s) and the terms of the partnership agreement. The kick-out rights must be substantive and exercisable without cause, and there must not be any significant barriers to exercising those rights. The substantive ability to dissolve (liquidate) the limited partnership would be considered equivalent to a kick-out right. However, withdrawal rights, with limited exceptions, are not deemed to be kick-out rights. See Section 7.3.1.3.3 for more guidance on assessing whether kick-out rights are substantive, including barriers to exercise.

A limited partner need not have a majority of the economic interests to consolidate a voting interest entity, if it holds a majority of the kick-out rights, as discussed in ASC 810-10-55-4V.

### Illustration C-1: Voting model: no party consolidates

Entity A, the general partner, forms a limited partnership and receives a management fee. Entity A holds no equity interest in the partnership. Entity B, Entity C and Entity D each hold 33.3% of the limited partnership interests. Entity A makes all of the significant decisions for the partnership, but limited partners with a simple majority of voting interests can remove the general partner without cause (assume there are no barriers to exercise the kick-out rights).

#### Analysis

The limited partnership is a voting interest entity because the limited partners with equity at risk are able to exercise a simple majority vote to remove the general partner without cause. (This example assumes that none of the other VIE criteria are met.) None of the limited partners has a majority of the limited partnership’s kick-out rights. Therefore, no limited partner would consolidate the limited partnership.
Illustration C-2: Voting model: limited partner consolidates

Assume the same facts as in Illustration C-1, except that Entity B, Entity C and Entity D hold 20%, 25% and 55% of the limited partnership interests respectively.

Analysis

The limited partnership is a voting interest entity because the limited partners with equity at risk are able to exercise a simple majority vote to remove the general partner without cause. (This example assumes that none of the other VIE criteria are met.) Entity D has a majority of the limited partnership’s kick-out rights. Therefore, Entity D would consolidate the limited partnership.

Illustration C-3: Voting model: real estate investment trust (REIT)

A real estate investment trust (REIT) holds an investment in a limited partnership through a 1% general partner interest and a 49% limited partner interest. The other 50% limited partner interest is held by Entity A, an unrelated party. The limited partnership was established to own and operate a commercial real estate asset. A subsidiary of the REIT serves as the property manager and earns a management fee that is customary and commensurate with the services provided.

The REIT and Entity A each appoint two members to a board of directors that must approve all significant decisions by a majority vote. Entity A is therefore deemed to hold substantive participating rights.

Analysis

The limited partnership is a voting interest entity because Entity A holds substantive participating rights. (This example assumes that none of the other VIE criteria are met.) Therefore, the REIT and Entity A would apply the voting model and neither of them would consolidate the limited partnership because neither has a majority of the limited partnership’s kick-out rights.

In December 2015, the FASB tentatively decided to add a project to its agenda to clarify when a not-for-profit entity that is a general partner should consolidate a for-profit limited partnership. We encourage readers to monitor developments in this area.

C.2.3 Circumstances when more than a simple majority is required for control

In most cases, owning more than 50% of the voting stock of a voting interest entity that is a corporation will result in majority voting control. However, it’s possible for a reporting entity to need more than a simple majority vote to have a controlling financial interest in a corporation.
Illustration C-4: Circumstance when more than a simple majority is required for control

A reporting entity owns 51% of a corporation that has a voting arrangement requiring approval from two-thirds of the outstanding voting interests for major decisions, rather than a simple majority.

Analysis

Only a holder of at least two-thirds of the outstanding voting stock would have control. Accordingly, the 51% voting holder would not consolidate the corporation.

A limited partnership that requires more than a simple majority vote to kick out the general partner will often be a VIE, as discussed in Section 7.3.1.3.2.

C.2.4 Evaluating indirect control

A reporting entity may indirectly control another entity through both direct ownership in the entity and indirect ownership through an investment in a controlled intermediate entity (or entities) that holds a voting interest or kick-out right in the indirectly controlled entity. The examples below describe scenarios in which indirect ownership either does or does not result in control. Each example is assumed to relate to a voting interest entity (i.e., an entity that is not a VIE), and all ownership interests represent voting interests.

Illustration C-5: Evaluating indirect control

Example 1

Company A owns 100% of Company B and 49% of Company C. Company B owns 10% of Company C.

Analysis

Company A controls Company C through direct and indirect ownership.

Example 2

Company A owns 51% of Company B, which owns 51% of Company C.

Analysis

Company A controls Company B and Company B controls Company C, therefore Company A indirectly controls Company C.
Conversely, the ultimate parent could have an economic interest of more than 50% of another entity but not have a controlling financial interest because it does not hold a majority voting interest or a majority of kick-out rights.

Illustration C-6: Parent has more than a 50% indirect economic interest, but does not control

Company A owns 35% of Company B and 35% of Company C. Company B owns 45% of Company C. All entities are voting interest entities (i.e., not VIEs), and all ownership interests represent voting interests.

Analysis

Company A has an economic interest of 50.75% in Company C (its 35% direct interest, plus its 35% of Company B’s 45% direct interest in Company C). However, Company A does not have a controlling financial interest in Company C, either directly or indirectly.

To explain further, Company A's direct interest in Company C (i.e., 35%) does not provide control. Company A does not have indirect control either, because it does not have a controlling financial interest in Company B (i.e., its interest is only 35%), which does not have a controlling financial interest in Company C (i.e., its interest is only 45%).

Alternatively, the ultimate parent could have an indirect controlling financial interest in another entity even if it has an indirect economic interest of less than 50% of the outstanding voting stock or kick-out rights in a limited partnership.

Illustration C-7: Parent controls with less than a 50% indirect economic interest

Company A owns 51% of Company B and 21% of Company C. Company B owns 30% of Company C. All entities are voting interest entities (i.e., not VIEs), and all ownership interests represent voting interests.

Analysis

Company A has an economic interest of 36.3% in Company C (i.e., its 21% direct interest, plus its 51% of Company B’s 30% direct interest in Company C). However, Company A does have a controlling financial interest in Company C (i.e., Company A controls 51% of Company C) because Company A controls Company B and thus can control Company B's voting interest in Company C.
C.2.5 Evaluating call options, convertible instruments and other potential voting rights

The Voting Model does not directly address potential voting rights. However, we believe the effect of options, warrants, preferred stock and conversion privileges generally should not be considered in determining whether an investor has ownership of a majority of the voting interests or a majority of the kick-out rights of a voting interest entity.

In certain circumstances, the terms and conditions of an instrument that provides potential voting rights may require further consideration of the substance of the arrangement (e.g., a fixed-price call option that is deep in the money with little economic outlay required to exercise) to determine whether the entity is a voting interest entity or a VIE. This determination would depend on a careful evaluation of the facts and circumstances. See Chapter 7 for interpretive guidance on determining whether an entity is a VIE. See also Section 8.2.4.4 on evaluating potential voting rights in a VIE.

C.2.6 Control when owning less than a majority of voting shares

In some limited circumstances, the SEC staff may require the consolidation of less-than-majority-owned corporations (or limited partnerships for which less than a majority of kick-out rights are held) under Regulation S-X, Rule 3A-02, Consolidated financial statements of the registrant and its subsidiaries. The conditions providing a reporting entity with control of a less-than-majority-owned corporation or of a limited partnership for which less than a majority of kick-out rights are held may require further consideration of whether the entity is a voting interest entity or a VIE. See Chapter 7 for guidance on determining whether an entity is a VIE.

Illustration C-8: Voting control when owning less than a majority of the voting shares

A registrant reduces its investment in the outstanding voting stock of a corporation to 47% from 80% but continues to maintain control of the board, which makes all significant decisions (i.e., the registrant’s employees had other-than-temporary control of the corporation’s board of directors by holding, for example, three of five seats). The corporation is a voting interest entity.

Analysis
The registrant would continue to consolidate the corporation because it maintains control of the board. The conditions providing the 47% owner with control of the board may require further consideration of whether the corporation is a voting interest entity or a VIE. See Chapter 7 for guidance on determining whether an entity is a VIE.

C.2.6.1 Evaluating size of minority investment relative to other minority investors

When a reporting entity holds less than a majority of the voting interests of a corporation or the kick-out rights of a limited partnership, the reporting entity should not consider the size of its investment relative to the investments of others to determine whether it has “effective” control of the entity (sometimes referred to as “de facto control”). That is, while the reporting entity’s holdings may be large when compared to those of other investors, that fact alone and the probability that the reporting entity will be able to exert effective control does not give the reporting entity a controlling financial interest in the entity.

Illustration C-9: Evaluating size of minority investment relative to those of other minority investors

Company A owns 40% of the voting interests of Company B. Sixty other investors each own 1% of the voting interests of Company B. Company B is a voting interest entity.

Analysis
While Company A may have “effective” control over the activities of Company B, Company A does not have the power to direct the activities of Company B and, accordingly, should not consolidate Company B.
C.3 Exceptions to consolidation by a reporting entity holding a majority of voting stock or limited partnership interests

**Excerpt from Accounting Standards Codification**

**Consolidation — Overall**

**Scope and Scope Exceptions — General**

810-10-15-10

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:

a. All majority-owned subsidiaries — all entities in which a parent has a controlling financial interest — shall be consolidated. However, there are exceptions to this general rule.

1. A majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner — for instance, if any of the following are present:
   i. The subsidiary is in legal reorganization
   ii. The subsidiary is in bankruptcy
   iii. 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.
   iv. 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.
   v. 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)...

As a general rule, unless the entity is a VIE, all majority-owned corporations and all limited partnerships for which a majority of kick-out rights are held should be consolidated. However, ASC 810-10-15-10 provides conditions when such an entity may not be consolidated.

One such condition is when the entity is in bankruptcy, including reorganizing under bankruptcy court protection. See Section 3.9.13 of our FRD, Bankruptcies, liquidations and quasi-reorganizations, for further discussion of the accounting considerations related to entities in, or entering into, bankruptcy.

In some circumstances, consolidation of an entity may not be appropriate when it operates under foreign exchange restrictions, controls or other governmentally imposed uncertainties so severe that they cast significant doubt on the reporting entity’s ability to control the entity. See Section C.3.1 for additional guidance.
Additionally, consolidation may not be appropriate when the rights of the reporting entity are restricted in certain respects by approval or veto rights granted to others (see Section C.3.2 for further discussion on evaluating the effect of noncontrolling rights).

C.3.1 Foreign currency exchange restrictions (Updated February 2016)

ASC 810-10-15-10(a)(1)(iii) states that control of a foreign entity may not rest with the majority owner under certain circumstances, including if the subsidiary operates under foreign exchange restrictions so severe that they cast significant doubt on the reporting entity’s ability to control the entity. ASC 830-20-30-2 further indicates that a lack of exchangeability is other than temporary, a reporting entity should carefully consider whether it is appropriate to consolidate, combine or apply the equity method to the foreign operation.

While reporting entities should consider the totality of their individual facts and circumstances, we generally do not believe that a lack of exchangeability in and of itself would result in the deconsolidation of a foreign subsidiary.

Rather, we believe that a reporting entity has a controlling financial interest when it has the ability to direct the activities that significantly affect the entity’s economic performance, including whether the reporting entity can select, terminate, and set the compensation of management responsible for implementing the entity’s policies and procedures, and establish operating and capital decisions for the entity.

In addition to limitations on exchangeability, factors to consider when evaluating whether it would be appropriate to deconsolidate an entity include:

- Pricing and/or profit restrictions
- Requirements to source materials from one or more state-owned entities
- Requirements to pay employee salaries for idle workforce
- Government prescription on the specific products and quantities to be produced

The SEC staff also has cautioned that before deconsolidating a subsidiary in such circumstances, careful consideration should be given to whether a subsidiary would be considered a VIE because power may no longer reside with the at-risk equity holders. As a result, the SEC staff stated that registrants should clearly disclose their judgments on and the financial reporting effect of deconsolidation. They should also consider the required disclosures for interests in VIEs that are not consolidated.

The SEC staff also indicated that if the conclusion to deconsolidate was based on foreign exchange restrictions and the severity of government-imposed controls, an improvement in exchangeability or loosening of government-imposed controls may result in the restoration of control and consolidation. The SEC staff said that they would expect consistency in a registrant’s judgments of whether it has lost control or regained control of a subsidiary and that registrants should have internal controls over that assessment.

---

C.3.2 Evaluating the effect of noncontrolling rights

**Excerpt from Accounting Standards Codification**

**Consolidation – Overall**

**Recognition**

**The Effect of Noncontrolling Rights on Consolidation**

**810-10-25-2**

Paragraph 810-10-15-10(a)(1)(iv) explains that, in some instances, the powers of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling shareholder or limited partner (referred to as noncontrolling rights). That paragraph also explains that, in paragraphs 810-10-25-2 through 25-14, the term noncontrolling shareholder refers to one or more noncontrolling shareholders and the term *limited partner* and *general partner* refer to one or more limited or general partners. Paragraph 810-10-15-10(a)(1)(iv) explains that those noncontrolling rights may have little or no impact on the ability of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the investee’s operations or assets, or, alternatively, those rights may be so restrictive as to call into question whether control rests with the majority owner.

**810-10-25-3**

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.

**810-10-25-5**

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 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.
An entity that is not controlled by the holder of a majority voting interest or holder of a majority of kick-out rights through voting interests because of noncontrolling shareholder or limited partner veto rights described in paragraphs 810-10-25-2 through 25-13 and 810-10-55-1 is not a VIE if the shareholders or partners as a group (the holders of the equity investment at risk) have the power to control the entity and the equity investment meets the other requirements of paragraphs 810-10-15-14 and 810-10-25-45 through 25-47, as applicable.

In certain cases, the majority owner of the outstanding voting stock or limited partnership interests of a voting interest entity may not control the operations or assets of the entity. This may occur because of restrictions placed on the majority owner or because of veto rights granted to the minority shareholders or minority limited partners (referred to collectively as the minority owners). Alternatively, those minority rights may have little or no effect on the ability of the majority owner to control the entity's operations or assets.

Rights (whether granted by contract or by law) that allow the minority owner(s) to effectively participate in the significant decisions that are made in the ordinary course of business (referred to as participating rights) prevent the majority owner from controlling entity (see Section C.3.2.1 for further discussion of participating rights).

Other rights may provide minority owners with the ability to block actions not in the ordinary course of business that were proposed by the majority owner to preserve the minority owners' investment in the entity. These rights are called protective rights and would not overcome the presumption of control by the majority owner (see Section C.3.2.2 for further discussion). Significant judgment is required to determine whether minority rights represent substantive participating rights or protective rights that do not affect the evaluation of control.

An entity that is not controlled by the majority owner because of veto rights held by a minority owner is not a VIE if the shareholders or limited partners as a group have the power to control the entity and the other characteristics of a VIE are not present (see Chapter 7 for further discussion of the characteristics of a VIE).

### C.3.2.1 Participating rights

**Excerpt from Accounting Standards Codification**

**Consolidation – Overall**

**Glossary**

**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.

**Recognition**

**The Effect of Noncontrolling Rights on Consolidation**

**810-10-25-6**

All noncontrolling rights could be described as protective of the noncontrolling shareholder's or limited partner's investment in the investee, but some noncontrolling rights also allow the noncontrolling shareholder or limited partner to participate in determining certain significant financial and operating
decisions of the investee that are made in the ordinary course of business (referred to as participating rights). Participation means the ability to block actions proposed by the investor that has a majority voting interest or the general partner. Thus, the investor with the majority voting interest or the general partner must have the agreement of the noncontrolling shareholder or limited partner to take certain actions. Participation does not mean the ability of the noncontrolling shareholder or limited partner to initiate actions.

810-10-25-7
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.

810-10-25-8
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.

Participating Rights
810-10-25-11
Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to effectively participate in either of the following corporate or partnership actions shall be considered substantive participating rights and would overcome the presumption that the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests shall consolidate its investee. The following list is illustrative of substantive participating rights, but is not necessarily all-inclusive:

a. Selecting, terminating, and setting the compensation of management responsible for implementing the investee's policies and procedures
b. Establishing operating and capital decisions of the investee, including budgets, in the ordinary course of business.

810-10-25-12
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.
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.

The Voting Model generally presumes that the majority owner of the outstanding voting stock or limited partnership interests of a voting interest entity controls and therefore must consolidate the entity, but there are certain situations when that presumption may be overcome.

One exception is when one or more of the minority owners hold substantive veto or approval rights, allowing them to effectively participate in significant decisions made in the ordinary course of business of the entity. Being able to effectively participate, in this case, means having the ability to block significant decisions in the ordinary course of business proposed by the majority owner. That is, the minority owners do not need to have the ability to initiate actions to participate. The likelihood that the minority owners will exercise a right to block significant decisions is not considered in the evaluation. While participating rights may prevent the majority owner from consolidating an entity, those rights do not cause the holder to consolidate the entity.

Decisions made in the ordinary course of business are defined in ASC 810-10-20 and ASC 810-10-25-8 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 events or transactions that would necessitate such decisions will occur.

ASC 810-10-25-11 states that the following actions are always significant decisions:

- Selecting, terminating and setting the compensation of management responsible for implementing the entity’s policies and procedures
- Establishing operating and capital decisions of the entity, including budgets, in the ordinary course of business

We do not believe that a minority owner must participate in both of these significant decisions to overcome the presumption that the majority owner controls the entity. However, we believe that in determining whether participation in either decision is substantive, the minority owner generally must have the ability to participate in all aspects of that decision for the participating right to be substantive. That is, the minority owner must have, for example, the right to select, terminate and set the compensation of management responsible for implementing the entity’s policies and procedures; having the right only to select management (but not also terminate and set compensation) would not be sufficient for the right to be substantive.

We also do not believe that the two decisions cited in ASC 810-10-25-11 are the only decisions that could be considered significant. Other significant decisions may be relevant in assessing whether any rights of the minority owners overcome the presumption of control by the majority owner.

We understand that a limited partner’s status may be challenged as a matter of law if that partner has the right to effectively participate in the partnership’s decision making. Accordingly, the limited partners’ rights should be evaluated carefully before determining that those rights are substantive participating rights.

Other rights, called protective rights, may provide minority owners with the ability to block actions not in the ordinary course of business and these would not overcome the presumption of control by the majority owner. (See Section C.3.2.2 for further discussion of protective rights.)

Judgment is required in determining whether the noncontrolling rights, individually or in the aggregate, give the minority owners participation in significant decisions that would be expected to be made in the ordinary course of business.
C.3.2.1.1 Evaluating the substance of noncontrolling rights

Excerpt from Accounting Standards Codification

Consolidation – Overall

Recognition – Factors to Consider in Evaluating Whether Noncontrolling Rights Are Substantive Participating Rights

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.

Participating rights must be substantive to overcome the presumption that the majority owner of the outstanding voting stock or limited partnership interests of a voting interest entity should consolidate the entity. ASC 810-10-25-13 provides factors to be considered when evaluating whether noncontrolling rights are substantive. The determination of whether participating rights are substantive is a matter of facts and circumstances and requires the use of professional judgment.

For noncontrolling rights to be considered substantive, the events or transactions to which they relate must have at least a reasonably possible chance of occurring. Further, these rights must have no significant barriers to exercise (i.e., significant penalties or other hurdles making it difficult or unlikely that they could be exercised).

When evaluating the substance of noncontrolling rights, it is important to understand the level at which significant decisions are made. For example, in a corporation or similar entity, significant decisions might be made by a direct vote of the shareholders, by a vote of the board of directors or by both methods. The rights must allow the minority shareholder to effectively participate in the significant decisions at the level at which those significant decisions are made.

As the disparity between the ownership interests of the majority owner and the minority owners increases, the rights held by the minority owners are presumptively more likely to be protective rights, meaning they may not be substantive (see Section C.3.2.2 for further discussion of protective rights).
Similarly, although a majority owner is presumed to control a voting interest entity, the likelihood of that presumption being overcome by the existence of substantive minority rights may increase as the majority owner’s financial interest in the entity decreases. If the majority owner owns a 90% interest, it may be less likely that the 10% owner would have significant minority rights that would preclude consolidation. However, in a 51%/49% situation, evaluating the significance of minority rights may be much more difficult and likely will require careful consideration of all facts and circumstances.

The likelihood that a veto right will be exercised by minority owners should not be considered when assessing whether a minority right is a substantive participating right (i.e., the probability that the minority owner will exercise its right is not considered).

The following examples, derived from the guidance in ASC 810-10-55-1, illustrate how to determine whether participating rights are substantive:

<table>
<thead>
<tr>
<th>Illustration C-10: Evaluating whether noncontrolling rights are substantive</th>
</tr>
</thead>
<tbody>
<tr>
<td>In the examples below, the term “majority owner” refers to a majority owner of the outstanding voting stock or the limited partnership interests of a voting interest entity. The term “minority owner” refers to a minority shareholder or limited partner of a voting interest entity.</td>
</tr>
</tbody>
</table>

**Example 1 — Approval of operating budgets**

The governance agreement for a voting interest entity provides that if the minority owners block the approval of the operating budget, the budget defaults to last year’s budget, adjusted for inflation. If the entity operated in a mature business for which year-to-year operating budgets would not be expected to vary significantly, the rights of the minority owners to block the approval of the operating budget do not allow the minority owners to effectively participate and are not substantive.

**Example 2 — Related party relationships**

The minority owners of a voting interest entity are related to the majority owner. The nature of the related party relationships should be evaluated to determine whether the minority owners’ participating rights are substantive. Rights held by the immediate family members or an entity that is under common control with the majority owner likely would not overcome the presumption of control by the majority owner.

**Example 3 — Incurring indebtedness**

It is reasonably possible or probable that a real estate entity will need to incur indebtedness in its ordinary course of business and that debt financing requires minority owner approval. In such a case, the rights of the minority owners would be viewed as substantive participating rights. Conversely, if the minority owners’ approval was required only for indebtedness to finance an acquisition that is not in the entity’s ordinary course of business, that approval by the minority owners would be considered a protective right.

**Example 4 — Operating or capital decisions**

The minority owners’ rights over operating or capital decisions must be significant to the ordinary course of business of the entity. Certain rights may deal with operating or capital decisions that are not significant to the ordinary course of business. For example, the ability to effectively participate in the decision to relocate the entity’s headquarters, change its name or select accounting principles would not overcome the presumption that the majority owner controls the entity.

In determining whether participating rights are substantive, the likelihood that the veto right will be exercised by the minority owners should not be considered. However, it must be at least reasonably possible that the events or transactions that require the minority owners’ approval will occur. If the chances of an event or transaction that requires the minority owners’ approval occurring are remote, that right would not be a substantive participating right.
### Example 5 – Majority owner’s right to buy out minority owners

A majority owner that has a contractual right to buy out the interest of the minority owners should consider the feasibility of exercising such a right when assessing whether the participating rights of the minority owners are substantive. If such a buyout is prudent, feasible and substantially within the control of the majority owner, the majority owner’s right to buy out the minority owners demonstrates that the minority owners’ rights are not substantive. However, it would not be prudent, feasible and substantially within the control of the majority owner to buy out the minority owners if, for example, (1) the minority owners control technology that is critical to the entity, (2) the minority owners are the principal source of funding for the entity or (3) the buyout contains a significant penalty that would serve as a barrier to exercise.

### Example 6 – Rights relating to dividends and other distributions

The minority owners’ rights relating to dividends and other distributions may be participating or protective and must be evaluated based on the facts and circumstances. For example, the rights to block customary or anticipated dividends or other distributions may be participating rights. However, the ability to block extraordinary dividends would be viewed as a protective right.

### Example 7 – Rights relating to a specific action

The minority owners’ rights with respect to a specific action of an entity may be protective or participating and must be evaluated based on the facts and circumstances. For example, the minority owners may be able to block a majority owner’s decision to lease property. However, if the majority owner could make a decision to purchase a property, rather than lease the property, without seeking the minority owners’ approval, the minority owners’ rights to block the majority owner from entering into the lease would be viewed as a protective right.

### Example 8 – Rights relating to negotiation of collective bargaining agreements

The minority owners’ rights to negotiate collective bargaining agreements with unions may be protective or participating and must be evaluated based on the facts and circumstances. For example, if a collective bargaining agreement does not cover a substantial portion of the entity’s workforce, the rights of the minority owners to participate in the negotiation of collective bargaining agreements may not be substantive.

### Example 9 – Rights relating to the initiation or resolution of a lawsuit

The minority owners’ rights to initiate or resolve a lawsuit may be protective or participating and must be evaluated based on the facts and circumstances. For example, if lawsuits are expected to be part of the entity’s ordinary course of business, the minority owners’ rights with respect to participation in lawsuits may be considered substantive.

### Example 10 – Rights to participate in termination of management

The minority owners’ rights to participate in the termination of management (e.g., management is outsourced to a party other than the majority owner) or the individual members of management may be substantive participating rights.
C.3.2.2 Protective rights

Excerpt from Accounting Standards Codification

Consolidation – Overall

Glossary

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.

Recognition

810-10-25-7

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.

810-10-25-10

Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to block corporate or partnership actions would be considered protective rights and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. The following list is illustrative of the protective rights that often are provided to the noncontrolling shareholder or limited partner but is not all-inclusive:

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

Other rights may allow minority owners to block actions not in the ordinary course of business proposed by the majority owner to preserve the minority shareholders' investment in the investee. Rights of this nature, whether granted by contract or by law, are considered protective rights and would not overcome the general rule of consolidation by the majority owner. ASC 810-10-25-10 provides examples of protective rights (the list is not all-inclusive).
Significant judgment is required to determine whether minority rights represent substantive participating rights or protective rights that do not affect the evaluation of control. While both represent an approval or veto right, a distinguishing factor is the underlying activity or action to which the right relates. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances, whereas participating rights provide the ability to block significant actions in the ordinary course of business.

C.3.2.3 Assessment of noncontrolling rights

The determination of whether the noncontrolling rights held by minority owners overcome the general rule that a majority owner of the outstanding voting stock or the limited partnership interests controls a voting interest entity should initially be made when an a reporting entity first becomes involved with the voting interest entity. That determination should be reassessed at each reporting period based on changes in facts and circumstances that would affect the rights of any of the interest holders as well as the ability of the interest holder to exercise such rights. The reassessment should include, but not be limited to, an evaluation of whether there was a change (1) to the terms or in the exercisability of the rights, (2) in the ownership of voting interests or (3) in the number of outstanding shareholders or limited partners.

Other changes may also affect the consolidation analysis. For example, if the minority owners’ rights to veto the annual operating and capital budgets expire after a period of time, the majority owner should reevaluate its consolidation conclusion after the veto rights expire. In certain instances, the changes in the facts and circumstances may represent a change in the purpose and design of the entity or otherwise constitute a reconsideration event (see Chapter 11 for further discussion). This investor may then have to determine whether the entity is a voting interest entity or a VIE.

Reporting entities should establish internal controls to identify changes that could affect the consolidation analysis in a timely fashion.

C.4 Control by contract

Entities that are not VIEs under the Variable Interest Model or identified as exceptions to the basic consolidation criteria may be controlled by contract in accordance with the guidance in ASC 810-10. However, we believe application of this guidance is limited because entities controlled by contract are often VIEs.

A reporting entity has a controlling financial interest in an entity through contractual arrangements when the following requirements have been met:

- The contractual term is either (1) the entire remaining legal life of the entity or (2) a period of 10 years or more.
- The contract is not terminable by the entity except in the case of gross negligence, fraud or other illegal acts by the reporting entity or bankruptcy of the reporting entity.
- The reporting entity has the exclusive authority over all decision making related to day-to-day operations of the entity, including the selection, hiring and firing of personnel.
- The reporting entity has a significant financial interest in the entity that is unilaterally saleable or transferable by the reporting entity.
- The reporting entity has the right to receive income, both as ongoing fees and as proceeds from the sale of its interest in the entity, in an amount that fluctuates based on the performance of the operations of the entity and the change in its fair value.

For additional guidance, see the Consolidation of Entities Controlled by Contract subsections of ASC 810-10.
Private Company Council alternative for lessors in common control leasing arrangements

Overview and scope

Excerpt from Accounting Standards Codification

Consolidation — Overall

Scope and Scope Exceptions — Variable Interest Entities

Accounting Alternative

\textbf{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:

\begin{enumerate}
  \item The private company lessee (the reporting entity) and the lessor legal entity are under common control.
  \item The private company lessee has a lease arrangement with the lessor legal entity.
  \item 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.
  \item 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.
\end{enumerate}

See paragraph 810-10-55-9 and paragraphs 810-10-55-205A through 55-205I for implementation guidance.

\textbf{810-10-15-17B}

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.

\textbf{810-10-15-17C}

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. The ASU allows private companies that do not meet the definition of a public business entity (further discussed in Section D.1.1) to choose to be exempt from applying the Variable Interest Model to lessors in common control leasing arrangements that meet certain criteria. The FASB's goal was to allow private companies to simplify their accounting for these arrangements, while continuing to provide relevant information to users of private company financial statements.

The guidance, which was developed by the Private Company Council (PCC), requires private companies to make an accounting policy election and apply the accounting to all current and future leasing arrangements that meet the criteria. A private company that elects this alternative would need to make certain disclosures about any qualifying arrangements. It also would continue to apply other consolidation guidance in ASC 810 and other applicable US GAAP to the arrangements, such as ASC 460 and ASC 840.

The PCC developed this alternative in response to concerns raised by private company financial statement users and preparers that, in some cases, applying the Variable Interest Model led private companies to consolidate lessors in common control leasing arrangements. These stakeholders said private companies design common control arrangements primarily for tax, estate-planning or legal liability purposes, not to structure off-balance sheet debt, and consolidation doesn't provide useful information. They noted that financial statement users generally focus on a private company's cash flows and financial position on a standalone basis. In some cases, users were requesting consolidation schedules to reverse the effects of consolidating the lessor in these arrangements.

Under the ASU, a private company can choose to apply the alternative when all of the following criteria are met:

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

Private companies that elect this alternative may still be required to record the leased assets on their books under other US GAAP. For example, under ASC 840's guidance on lessee involvement in asset construction, a private company could be considered the owner of an asset during construction if it provides debt guarantees or assumes obligations to fund construction cost overruns, among other things. This could result in a private company recording the asset on its books.

If the private company is considered the asset owner, it must also apply the sale-leaseback provisions of ASC 840-40 (and ASC 360-20 for real estate assets) to evaluate when the asset should be derecognized. This guidance might lead to counterintuitive results, such as the lessee's continued recognition of the asset in the case of a failed sale-leaseback.

---

1 Refer to Chapter 2 for the definition of a private company from the ASC Master Glossary
2 ASU 2013-12, Definition of a Public Business Entity, defined a public business entity.
**D.1.1 Definition of a private company and public business entity**

Only private companies are eligible to elect the accounting alternative. The FASB defined a private company as “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.” Therefore, companies that are considering adopting the accounting alternative should carefully review the new definition of a public business entity because the new definition includes several types of entities that would not be considered public under other existing definitions in US GAAP. For example, an entity is considered a public business entity if its financial statements (or financial information) are included in another company's Securities and Exchange Commission (SEC) filing (e.g., an acquired business, significant equity method investee).

A public business entity is defined as:

“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.”

Because the definition of a public business entity is broader than other definitions of public company in US GAAP, private companies should carefully evaluate whether they still meet the definition of a private company, and whether they expect to continue to meet it for the foreseeable future. For example, if a company meets the definition of a private company (and therefore is currently eligible to apply the accounting alternative), but later goes public, it would be required to retrospectively adjust its historical financial statements to comply with public company US GAAP. This could be challenging and could affect other aspects of the financial statements.
D.2  Evaluating common control

To apply the alternative, a private company must be under “common control” with the lessor. This term is not defined in the Accounting Standards Codification. Current practice is to consider the guidance from the SEC staff discussed by the EITF in the abstract on EITF Issue 02-5 (the EITF didn’t reach a consensus on this issue). Specifically, the abstract on EITF Issue 02-5 indicates that common control exists only in the following situations:

- An individual or entity holds more than 50% of the voting ownership interest of each entity.
- Immediate family members hold more than 50% of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert). Immediate family members include a married couple and their children but not the married couple’s grandchildren. Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration of the substance of the ownership and voting relationships.
- A group of shareholders holds more than 50% of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities’ shares in concert exists.

For purposes of applying the private company alternative, however, the FASB said in the Basis for Conclusions in ASU 2014-07 that it used the term more broadly than what is considered common control in current practice. In particular, the FASB said an entity owned by a grandparent and an entity owned by a grandchild could qualify as being under common control, depending on the facts and circumstances.

Because the Codification does not currently define common control, evaluating whether a private company could apply the alternative may require significant judgment.

D.3  Identifying a leasing arrangement

While the new guidance does not define “leasing arrangement,” ASC 840-10-15 provides a model for determining whether an arrangement contains a lease. Refer to Chapter 1 of our Financial Reporting Developments publication, Lease accounting, for additional guidance on evaluating whether an arrangement is or contains a lease within the scope of ASC 840.

D.4  Evaluating whether activities relate to the leasing activities

Private companies may engage in the following activities that meet the criterion of being related to the leasing activities (including supporting leasing activities) between the two entities:

- Guaranteeing or providing collateral to the lender of a lessor for indebtedness that is secured by the asset leased by the private company
- Being an obligor in a joint and several liability arrangement for indebtedness of the lessor that is secured by the asset leased by the private company
- Maintaining, paying property taxes owed on the asset and negotiating the financing for the asset leased by the private company
- Paying income taxes of the lessor, when the only asset the lessor owns is the asset leased by the private company or by both the private company and an unrelated party

3 See Appendix C of our Financial Reporting Developments (FRD), Business combinations, for further interpretive guidance on evaluating common control.
Entering into a purchase commitment for the acquisition of or the support of the asset leased by the private company

A private company engaging in the following activities would not meet this criterion:

- Paying income taxes owed on an asset of the lessor that the private company is not leasing
- Entering into a commitment to purchase products produced by the lessor or to sell products to the lessor

D.5 **Evaluating a guarantee or collateralization of a leasing entity’s obligations**

The FASB added the fourth criterion limiting private company guarantees and collateral to mitigate the risk that leasing arrangements could be used to structure off-balance sheet debt. Without this anti-abuse provision, the FASB was concerned a private company could, for example, avoid applying the Variable Interest Model when it provided guarantees or collateral to a highly leveraged lessor with which it had a leasing arrangement on an insignificant asset.

D.6 **Illustrations**

The following illustrations, which are derived from the ASU, show how the guidance would apply in different situations.

<table>
<thead>
<tr>
<th>Illustration D-1: Applying the guidance to common control leasing arrangements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 1 — General</strong></td>
</tr>
<tr>
<td>A private company leases a manufacturing facility from a lessor with which it is under common control. The common owner has guaranteed the lessor’s mortgage on the facility. Assets of the private company are pledged as collateral on the mortgage.</td>
</tr>
<tr>
<td>The lessor does not own any other assets. The private company pays the property taxes on the facility it leases and maintains it. The value of the facility exceeds the principal amount of the mortgage at the inception of the collateral arrangement with the private company.</td>
</tr>
<tr>
<td><strong>Analysis</strong></td>
</tr>
<tr>
<td>The private company meets the criteria to apply the alternative. The private company and the lessor have a lease arrangement and are under common control. Substantially all the activities between them relate to their leasing arrangement. Further, the value of the facility exceeds the principal amount of the lessor’s mortgage at the inception of its collateral arrangement with the private company.</td>
</tr>
<tr>
<td><strong>Example 2 — Leased asset value declines below principal balance of obligation</strong></td>
</tr>
<tr>
<td>Assume the same facts as Example 1, except that in two years, the value of the manufacturing facility declines below the principal amount of the mortgage.</td>
</tr>
<tr>
<td><strong>Analysis</strong></td>
</tr>
<tr>
<td>The private company continues to meet the criteria to apply the alternative because the value of the facility exceeded the principal amount of the mortgage at the inception of the collateral arrangement. Subsequent changes in the value of the leased asset do not affect this conclusion.</td>
</tr>
</tbody>
</table>

---

4 The examples are codified in ASC 810-10-55-205C through 55-205I.
Example 3 – Principal balance of refinanced obligation exceeds value of leased asset

Assume the same facts as Example 1, except that in two years, the mortgage is refinanced, and the principal balance now exceeds the value of the facility. A condition of the new mortgage is that the private company provides additional collateral.

Analysis

The private company no longer meets the criteria to apply the alternative because the value of the facility is less than the principal amount of the mortgage at the inception of the new collateral arrangement.

When the criteria are no longer met, a private company must evaluate the lessor for consolidation by first applying the Variable Interest Model. This does not necessarily mean that the private company would need to consolidate the lessor.

Example 4 – Excess capacity of leased asset leased to other parties

Assume the same facts as Example 1, except that the facility has 10 floors and the private company leases only three of them. The remaining seven floors are leased to unrelated parties. Assets of the private company continue to be pledged as collateral on the mortgage that financed the purchase of the entire facility (i.e., all 10 floors).

Analysis

The private company meets the criteria to apply the alternative. In particular, substantially all of the activities between the private company and the lessor relate to the lease of the facility to the private company, even though the lessor is leasing excess capacity (i.e., seven floors) of the facility to unrelated parties. The arrangement also meets the fourth criterion because the value of the facility exceeded the principal amount of the mortgage at the inception of the collateral arrangement.

Example 5 – Lessor buys a separate asset and leases it to other parties

Assume the same facts as Example 1, except that the lessor obtains an additional mortgage to finance the acquisition of a new manufacturing facility, which is leased only to unrelated parties. The value of the new facility is significant to the lessor, and assets of the private company are pledged as collateral on the additional mortgage.

Analysis

The private company fails to meet the criteria to apply the alternative because it is engaging in substantial activities with the lessor outside of leasing activities by providing a guarantee on an asset that it is not leasing.

Example 6 – Lessor operates a separate asset that is not part of the collateral arrangement

Assume the same facts as Example 1, except that the lessor also owns and operates a separate manufacturing facility. There is no mortgage related to the separate facility, and the private company does not provide any guarantees or collateral related to that facility.

Analysis

The private company meets the criteria to apply the alternative because there are no activities between it and the lessor that relate to the separate facility.
Example 7 – Private company purchases products produced by the lessor

Assume the same facts as in Example 6, except that the private company has a commitment to purchase a significant amount of products manufactured by the separate facility.

Analysis

The private company fails to meet the criteria to apply the alternative because, by purchasing products manufactured by the separate facility, it is engaging in substantial activities with the lessor outside of leasing activities.

D.7 Disclosure

Excerpt from Accounting Standards Codification

Consolidation — Overall
Disclosure — Variable Interest Entities
Accounting Alternative

810-10-50-2AD
A private company lessee that does not apply the requirements of the Variable Interest Entities Subsections to one or more lessor legal entities because it meets the criteria in paragraph 810-10-15-17A shall disclose the following:

a. The amount and key terms of liabilities (for example, debt, environmental liabilities, and asset retirement obligations) recognized by the lessor legal entity that expose the private company lessee to providing financial support to the legal entity. For example, a private company lessee exposed to debt of the legal entity should disclose information such as the amount of debt, interest rate, maturity, pledged collateral, and guarantees associated with the debt.

b. A qualitative description of circumstances (for example, certain commitments and contingencies) not recognized in the financial statements of the lessor legal entity that expose the private company lessee to providing financial support to the legal entity.

810-10-50-2AE
In applying the disclosure guidance in paragraph 810-10-50-2AD, a private company lessee shall consider exposures through implicit guarantees. The determination as to whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:

a. There is an economic incentive for the private company lessee to act as a guarantor or to make funds available.

b. Such actions have happened in similar situations in the past.

c. The private company lessee acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

810-10-50-2AF
In disclosing information about the lessor legal entity, a private company lessee shall present the disclosures in combination with the disclosures required by other guidance (for example, in Topics 460 on guarantees, 850 on related party disclosures, and 840 on leases). Those disclosures could be combined in a single note or by including cross-references within the notes to financial statements.
A private company that elects the alternative would not have to make the VIE disclosures but must make the following new disclosures about the arrangement:

- The amount and key terms of the lessor’s recognized liabilities (e.g., debt, environmental liabilities, asset retirement obligations) that expose the private company to providing financial support to the lessor
- A qualitative description of circumstances (e.g., certain commitments and contingencies) not recognized in the financial statements of the lessor that expose the private company to providing financial support to the lessor

When making these disclosures, a private company must consider exposures through implicit guarantees. An implicit guarantee might involve expectations that the private company would make funds available (1) to the lessor to prevent the common owner’s guarantee of the lessor’s debt from being called on or (2) to the common owner to fund all or a portion of the call on that guarantee. The determination of whether an implicit guarantee exists is based on facts and circumstances, which include considering whether:

- There is an economic incentive for the private company to act as a guarantor or to make funds available.
- The private company has made funds available in similar situations in the past.
- The private company acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

Private companies must present these disclosures in combination with other disclosures about the arrangement required by existing guidance (e.g., ASC 460, 840, 850) by either providing all of them in one place or by cross-referencing them in the notes to the financial statements.

**D.8 Elimination of implicit variable interest guidance applicable to all entities**

The Variable Interest Model requires a reporting entity to consider whether it has any implicit variable interests in an entity (e.g., an implied guarantee related to certain obligations of the entity). ASU 2014-07 superseded paragraph 810-10-25-48 and an example in paragraphs 810-10-55-87 through 55-89, which suggested that implicit variable interests commonly arise in leasing arrangements among related parties. The FASB was concerned that retaining this guidance might cause confusion because it suggested that lessees could be required to apply the Variable Interest Model when they would qualify for an exemption from applying it under the private company alternative.

We do not believe that the FASB intended the elimination of this guidance to have a significant effect on current practice. That is, a reporting entity that applies the Variable Interest Model should continue to evaluate whether it has an implicit variable interest in an entity and therefore is subject to consolidating that entity.

**D.9 Effective date and transition**

In October 2015, the FASB issued a proposal developed by the PCC that would eliminate the effective date in this PCC alternative and would allow private companies to forgo a preferability assessment the first time they adopt it. The FASB said the proposal would give private companies the flexibility to adopt an alternative at a later date (e.g., if a private company chose not to adopt an alternative because it

---

5 See Section 5.4.12 for further interpretive guidance on identifying implicit variable interests.
planned to go public but then decided not to do so and wanted to adopt the PCC alternative at a future date). Under the proposal, this relief (the ability to adopt the PCC alternative without determining its preferability) would be provided only once, the first time a private company adopted the alternative. That is, a private company that elected to apply the alternative could not subsequently change this election without first demonstrating that the change in accounting policy is preferable.

The proposal also would indefinitely extend the transition guidance in the alternatives so that a company adopting each PCC alternative would follow the transition guidance in that alternative rather than ASC 250. We expect the FASB to move quickly on this proposal because if it is not finalized, calendar-year private companies would need to decide whether to elect this alternative before making their 2015 financial statements available for issuance because this alternative is effective for fiscal years beginning after 15 December 2014. We encourage readers to monitor developments in this area.

**Excerpt from Accounting Standards Codification**

**Consolidation – Overall**

**Implementation Guidance and Illustrations – Variable Interest Entities**

**Accounting Alternative**

**Transition Related to Accounting Standards Update No. 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements**

810-10-65-4

The following represents the transition and effective date information related to Accounting Standards Update No. 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements:

a. The pending content that links to this paragraph shall be effective for the first annual period beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015.

b. Early application is permitted for any annual or interim period before which an entity’s financial statements are available to be issued.

c. The pending content that links to this paragraph shall be applied retrospectively to all periods presented.

d. If a reporting entity deconsolidates a variable interest entity (VIE) as a result of the application of the pending content that links to this paragraph, the reporting entity shall initially measure any retained interest in the deconsolidated VIE at its carrying amount at the date the pending content that links to this paragraph first applies. 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 VIE. 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 deconsolidated VIE shall be recognized as a cumulative-effect adjustment to retained earnings. The amount of any cumulative-effect adjustment related to deconsolidation shall be disclosed separately.

e. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 except for the disclosure in paragraph 250-10-50-1(b)(2) in the period the entity adopts the pending content that links to this paragraph.
The guidance is effective for annual periods beginning after 15 December 2014 and for interim periods within annual periods beginning after 15 December 2015. Early adoption is permitted for any annual or interim period for which an entity’s financial statements have not yet been made available for issuance.

Private companies that elect the alternative are required to apply it retrospectively.

If a private company deconsolidates an entity as a result of applying the alternative, the transition provisions are similar to those provided in FAS 167 (see Chapter 14 for further interpretive guidance on these transition provisions). That is, the private company would initially measure any retained interest in that entity at its carrying amount upon adoption. Carrying amount refers to the amount at which the private company would have carried the interest in its financial statements if the alternative had been effective when it first became involved with the entity. Any difference between this amount and the carrying amount of the net assets of the deconsolidated entity would be recognized as a cumulative-effect adjustment to retained earnings. The amount of this adjustment would be disclosed separately.

In the period in which a private company adopts this alternative, it also would have to make certain disclosures required by ASC 250 about a change in accounting principles.
Measurement alternative for consolidated collateralized financing entities

E.1 Overview

Under US GAAP the primary beneficiary of a collateralized financing entity (CFE) may be required or may elect to measure the financial assets and the financial liabilities of a consolidated CFE at fair value. Under ASC 820, the fair value of a CFE’s financial assets may differ from the fair value of its financial liabilities even when the financial liabilities have recourse only to the related financial assets of the CFE.

In August 2014, the FASB issued ASU 2014-13 to eliminate this potential measurement difference by providing a measurement alternative under which the primary beneficiary may elect to measure both the CFE’s financial assets and financial liabilities using the fair value of either the CFE’s financial assets or financial liabilities, whichever is more observable.

ASU 2014-13 sets certain scope requirements to qualify for the alternative. It also provides an exception that will allow entities to apply the measurement alternative to certain consolidated CFES that would not otherwise meet the scope requirements when they adopt the standard.

E.2 Scope

Excerpt from Accounting Standards Codification
Consolidation — Overall
Scope and Scope Exceptions
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.

Under the guidance, an entity can use the alternative if it consolidates a CFE and meets both of the following conditions:

- All of the financial assets and the financial liabilities of the CFE are measured at fair value in the consolidated financial statements under other applicable GAAP, other than financial assets and financial liabilities that are incidental to the CFE’s operations and have carrying values that approximate fair value (e.g., cash, broker receivables, broker payables).

- The changes in the fair values of those financial assets and financial liabilities are reflected in earnings.
As described in Section 2.16, the ASU defines a CFE as a VIE that holds financial assets, issues beneficial interests in those assets and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the CFE and are classified as financial liabilities. A CFE may hold nonfinancial assets temporarily if a debtor defaults on the underlying debt instruments it holds or if it is trying to restructure debt instruments it holds. A CFE also may hold other financial assets and financial liabilities that are incidental to its operations and have carrying values that approximate fair value (e.g., cash, broker receivables, broker payables).

Specific scope requirements must be met because the Board did not want to change when a reporting entity could apply ASC 820. Rather, the Board’s intent was to provide an alternative on how a reporting entity can measure the financial assets and financial liabilities of a consolidated CFE when those assets and liabilities are already in the scope of ASC 820.

### E.3 Initial measurement

**Excerpt from Accounting Standards Codification**

**Consolidation**

**Overall**

**Initial Measurement** — **Variable Interest Entities**

**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.

**810-10-30-11**

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).

**810-10-30-12**

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)x(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.
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:

<table>
<thead>
<tr>
<th>a. The sum of:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The fair value of the financial liabilities (other than the beneficial interests retained by the reporting entity)</td>
</tr>
<tr>
<td>2. The fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)</td>
</tr>
<tr>
<td>3. The reporting entity’s carrying value of any beneficial interests that represent compensation for services</td>
</tr>
<tr>
<td>b. The carrying value of any nonfinancial assets held temporarily.</td>
</tr>
</tbody>
</table>

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.

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.

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.

If a reporting entity does not elect to apply the measurement alternative to a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, the reporting entity shall measure the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity using the requirements of Topic 820 on fair value measurement. If Topic 820 is applied, any initial difference in the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

The manner in which the alternative is applied will depend on which fair value is more observable. This could change over time. See ASC 810-10-55-205AS and 205AT for implementation guidance and illustrations.

The guidance also clarifies that a reporting entity that does not elect the alternative will reflect any difference between the fair values of a consolidated CFE’s financial assets and financial liabilities in earnings and will attribute these differences to the reporting entity (i.e., controlling interest holder) in the consolidated statement of income (loss). The Board clarified this point to eliminate diversity in practice.
Subsequent measurement

Excerpt from Accounting Standards Codification

Consolidation – Overall
Subsequent Measurement – Variable Interest Entities

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.

810-10-35-7
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.

810-10-35-8
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).

810-10-35-9
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).

If a consolidated CFE that qualified for the measurement alternative in one period fails to meet the criteria in another period (e.g., if it holds financial assets measured at amortized cost), the reporting entity cannot apply the measurement alternative in the subsequent period. Instead, the reporting entity will have to separately measure the CFE’s financial assets and financial liabilities.
E.5 Disclosure

Excerpt from Accounting Standards Codification

Consolidation – Overall

Disclosure – Variable Interest Entities

810-10-50-20
A reporting entity that consolidates a collateralized financing entity and measures the financial assets and the financial liabilities using the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8 shall disclose the information required by Topic 820 on fair value measurement and Topic 825 on financial instruments for the financial assets and the financial liabilities of the consolidated collateralized financing entity.

810-10-50-21
For the less observable of the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity that is measured in accordance with the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8, a reporting entity shall disclose that the amount was measured on the basis of the more observable of the fair value of the financial liabilities and the fair value of the financial assets.

810-10-50-22
The disclosures in paragraphs 810-10-50-20 through 50-21 do not apply to the financial assets and the financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value.

Excerpt from Accounting Standards Codification

Consolidation – Overall


810-10-65-6
The following represents the transition and effective date information related to Accounting Standards Update No. 2014-13, Consolidation (Topic 810): Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity:

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

b. Upon adoption, a reporting entity may apply the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8 to any existing consolidated collateralized financing entity that meets the scope requirements of paragraph 810-10-15-17D using a modified retrospective approach by remeasuring the financial assets or the financial liabilities of the existing consolidated collateralized financing entity as of the beginning of the annual period of adoption and recording a cumulative-effect adjustment for the remeasurement to equity. Any reporting entity that does not elect to apply the measurement alternative shall reclassify any accumulated differences in the fair value of the financial assets and the fair value of the financial liabilities of its collateralized financing entity to retained earnings if those differences were previously presented in another caption within equity (for example, appropriated retained earnings).

c. A reporting entity also may elect to apply the pending content that links to this paragraph retrospectively to all relevant prior periods beginning with the annual period in which the amendments in Accounting Standards Update No. 2009-17, Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities, were initially adopted.

d. A reporting entity that consolidates a collateralized financing entity that does not meet the scope requirements in paragraph 810-10-15-17D because the fair value option in Topic 825 was not elected to measure the eligible financial assets, financial liabilities, or both of the collateralized financing entity when it was initially consolidated, may elect at the date of adoption to apply the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8 to those financial assets and financial liabilities or to continue using the guidance in other Topics to measure the financial assets and the financial liabilities of the consolidated collateralized financing entity. A reporting entity that does not elect to use the measurement alternative may not elect at the date of adoption to use the measurement requirements of Topic 820 on fair value measurement or to otherwise change its basis for measuring the financial assets or the financial liabilities of the collateralized financing entity.

e. Earlier application of the pending content that links to this paragraph is permitted as of the beginning of an annual period.

f. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period the entity adopts the pending content that links to this paragraph.

For public business entities, the guidance is effective for annual periods beginning on or after 15 December 2015 and interim periods within that year. For other entities, it is effective for annual periods ending after 15 December 2016 and interim periods within annual periods beginning after 15 December 2016. Early adoption is permitted as of the beginning of an annual period.

A reporting entity may apply the guidance using a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the annual period of adoption. A reporting entity also may apply the amendments retrospectively to all relevant prior periods beginning with the annual period in which the amendments in ASU 2009-17 were initially adopted.
Further, the guidance provides an exception for reporting entities whose consolidated CFEs don’t meet the scope requirements because the entities didn’t elect the fair value option in ASC 825 when they initially consolidated the CFEs. The ASU allows them to elect, only at the date of adoption, to apply the measurement alternative to the CFEs’ financial assets and financial liabilities or continue using other US GAAP. However, entities that choose not to use this exception may not elect at the date of adoption to apply ASC 820 on fair measurement or to otherwise change their basis for measuring the financial assets or financial liabilities of the CFE. The EITF concluded that this exception was appropriate because some entities may not have elected the fair value option upon initial consolidation of a CFE because it was unclear how to address the measurement difference between the fair value of the financial assets and the fair value of the financial liabilities.
F Investment companies

F.1 Overview

ASC 946 provides guidance on determining whether an entity is an investment company. Investments in non-investment companies made by an investment company are accounted for in accordance with ASC 946 and are not subject to consolidation or the disclosure requirements of ASC 810.

F.1.1 Attributes of an investment company

Excerpt from Accounting Standards Codification

Financial Services — Investment Companies — Overall

Scope and Scope Exceptions

946-10-15-4
An entity regulated under the Investment Company Act of 1940 is an investment company under this Topic.

946-10-15-5
An entity that is not regulated under the Investment Company Act of 1940 shall assess all the characteristics of an investment company in paragraphs 946-10-15-6 through 15-7 to determine whether it is an investment company. The entity shall consider its purpose and design when making that assessment.

946-10-15-6
An investment company has the following fundamental characteristics:

a. It is an entity that does both of the following:
   1. Obtains funds from one or more investors and provides the investor(s) with investment management services
   2. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both.

b. The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

946-10-15-7
An investment company also has the following typical characteristics:

a. It has more than one investment.

b. It has more than one investor.

c. It has investors that are not related parties of the parent (if there is a parent) or the investment manager.
An entity that is regulated by the SEC under the 1940 Act automatically qualifies as an investment company.

Entities that are not regulated under the 1940 Act must have certain fundamental characteristics and consider other typical characteristics to determine whether they qualify as investment companies. An entity should consider its purpose and design when making this assessment.

An entity that does not have all of the fundamental characteristics would not be an investment company. An entity that does not have one or more of the typical characteristics could conclude that it is an investment company, but it would have to apply judgment and determine, considering all facts and circumstances, that its activities are consistent with those of an investment company.

**F.2 Consolidation by an investment company**

**Excerpt from Accounting Standards Codification**

**Financial Services – Investment Companies**

**Application of Consolidation Guidance**

*946-810-45-2*

Except as discussed in the following paragraph, consolidation by an investment company of an investee that is not an investment company is not appropriate. Rather, those controlling financial interests held by an investment company shall be measured in accordance with guidance in Subtopic 946-320, which requires investments in debt and equity securities to be subsequently measured at fair value.

*946-810-45-3*

An exception to the general principle in the preceding paragraph occurs if the investment company has an investment in an operating entity that provides services to the investment company, for example, an investment adviser or transfer agent (see paragraph 946-10-55-5). 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. If an investment company holds a controlling financial interest in such an operating entity, the investment company should consolidate that investee, rather than measuring the investment at fair value.
Investments in non-investment companies made by an investment company are accounted for in accordance with ASC 946 and are not subject to consolidation or the disclosure requirements of ASC 810. ASC 946 requires investments in debt and equity securities to be subsequently measured at fair value.

An exception to this general principle occurs if the investment company has an investment in an operating entity that provides services to the investment company, such as an investment adviser or transfer agent. When the investment company has a controlling financial interest in the operating entity (as determined under ASC 810), the investment company consolidates such operating entity rather than measuring it at fair value.

ASC 946 is silent on whether an investment company should consolidate another investment company that it controls. However, SEC Regulation S-X provides the following guidance:

**Excerpt from SEC Regulation S-X**

**Article 3**

**210.3A-02 Consolidated financial statements of the registrant and its subsidiaries.**

In deciding upon consolidation policy, the registrant must consider what financial presentation is most meaningful in the circumstances and should follow in the consolidated financial statements principles of inclusion or exclusion which will clearly exhibit the financial position and results of operations of the registrant. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one entity directly or indirectly has a controlling financial interest in another entity.

**S-X Rule 6-03(c) Special rules of general application to registered investment companies**

**Consolidated and combined statements**

(1) Consolidated and combined statements filed for registered investment companies shall be prepared in accordance with §§210.3A-01 to 210.3A-05 (Article 3A) except that

   (i) statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies;
   
   (ii) a consolidated statement of the registrant and any of its investment company subsidiaries shall not be filed unless accompanied by a consolidating statement which sets forth the individual statements of each significant subsidiary included in the consolidated statement: provided, however, that a consolidating statement need not be filed if all included subsidiaries are totally held; and
   
   (iii) consolidated or combined statements filed for subsidiaries not consolidated with the registrant shall not include any investment companies unless accompanied by consolidating or combining statements which set forth the individual statements of each included investment company which is a significant subsidiary.

**S-X Rule 1-02(aa) Definitions of terms used in Regulation S-X**

**Wholly owned subsidiary.** The term wholly owned subsidiary means a subsidiary substantially all of whose outstanding voting shares are owned by its parent and/or the parent's other wholly owned subsidiaries.

Practice is mixed, but investment companies often consolidate wholly owned investment companies. In addition, the SEC staff has expressed views regarding the accounting by an investment company for its involvement in other investment companies, including substantially wholly owned investment companies. Such investment companies may include business development companies (BDCs) or registered investment companies (RICs).
Non-authoritative literature


BDCs with Wholly Owned Subsidiaries

In reviewing registration statements and financial statements, the staff has observed a number of BDCs that have wholly owned subsidiaries, for example, in order to facilitate investment in a portfolio company. Certain of these BDCs do not consolidate such subsidiaries, even though the design and purpose of the subsidiary (e.g., a holding company) may be to act as an extension of the BDC’s investment operations and to facilitate the execution of the BDC’s investment strategy. As part of the registration statement and financial statement review process, the staff has generally suggested BDCs consolidate such subsidiaries, because the staff believes that consolidation provides investors with the most meaningful financial presentation in those statements.

Illustration F-1: Accounting for investments by an investment company

Investment company Z has a controlling financial interest in two operating entities, Operating entity A and Operating entity B, through holding 100% and 80% of their equity interests, respectively. Operating entities A and B do not provide services to Investment company Z. Investment company Z also has a controlling financial interest in Entity C, which acts as a holding company for Investment company Z’s interests in Operating entity D and Operating entity E and facilitates the execution of the Investment company Z’s investment strategy.

Investment company Z accounts for its investments in accordance with ASC 946. Entity C also meets the definition of an investment company and accounts for its investments in accordance with ASC 946.

Analysis

Because Investment company Z applies the guidance in ASC 946, the scope exception from the consolidation guidance in ASC 810-10-15-12(d) applies.

Investment company Z would not evaluate its equity investments in Operating entities A or B as potential variable interests requiring consolidation of those entities under the Variable Interest Model or Voting Model. Instead, Investment company Z would record each of its equity investments at fair value (i.e., recognize each equity investment as a single unit of account). Investment company Z would recognize and measure its equity investments in Operating entities A and B at $100 and $80, respectively.
Because Entity C is a holding company that is acting as an extension of Investment company Z and facilitates the execution of the Investment company Z's investment strategy, it would be consolidated by Investment Company Z. Investment company Z would recognize and measure Entity C’s equity investments in Operating entities D and E at $70 and $60, respectively.

F.2.1 Master/feeder and fund of funds structures

Two common fund structures are a master/feeder structure and a fund of funds structure, which are tiered investment structures that allow managers to more efficiently manage investments for diversified investors in different tax or legal jurisdictions, or to facilitate investments in multiple different funds. A diagram of a typical master/feeder structure follows:

Master/feeder fund structure

In a typical master/feeder structure, capital contributions are made by (1) US investors to an onshore feeder fund and (2) tax-exempt or foreign investors to an offshore feeder fund. The onshore feeder fund is typically an unregistered pooled investment company that is open to accredited US investors, legally structured as a limited partnership. The offshore feeder fund also typically is an unregistered pooled investment company, but is domiciled outside the US, and is open only to accredited non-US investors and accredited US tax-exempt investors. Offshore funds are often structured as limited companies (LTDs) based in Bermuda or the Cayman Islands.

The number of investors in the feeder funds may be restricted. A feeder fund is not limited to investing in a single master fund; it may invest in multiple master funds, other investments or other funds. Similarly, a master fund may have more than one onshore feeder or offshore feeder. The portfolio of the master fund may include, for example, equity securities, fixed-income securities, investments in other investment companies and derivatives.
The general partner and/or the investment adviser, which are typically related parties or under common control, serve as investment adviser with overall management and operations responsibilities. The general partner and/or investment adviser typically receives a management fee and a performance fee, which typically is 20% of profits, as that term is defined in the funds’ governing documents. The investors in the feeder funds may be able to redeem their interests in the fund at a price equal to the prevailing net asset value after an initial lock-up period. In most cases, the investors are not able to sell, transfer or encumber their interests in the feeder funds without the general partner’s approval.

A diagram of a fund of funds structure follows:

**Fund of funds structure**

In a typical fund of funds structure, a general partner, which could be either an LLC or a limited partnership, typically has a small ownership interest in the fund of funds, and receives a performance allocation (i.e., a share of the profits, often referred to as a carried interest), with the remaining profits being paid to the limited partner investors.

An investment adviser, which is typically an LLC or sub-chapter S corporation, receives a management fee from the fund. The general partner and investment adviser are typically related parties and/or under common control.

The fund of funds invests in other investment partnerships that may not be managed by the same general partner.

**F.2.1.1 SEC staff views on consolidation in master/feeder and fund of funds structures**

**Non-authoritative literature**


**Registered Investment Companies (RICs) that are Feeder Funds or Funds of Funds**

The staff has observed that a RIC that is a feeder fund in a master-feeder structure, or a RIC that is a fund of funds in the same group of investment companies, may have “a controlling financial interest in another entity” for purposes of Regulation S-X. In a master-feeder arrangement, the securities issued by the master fund are the only investment securities held by the RIC feeder fund and may constitute a controlling financial interest in the master fund. A RIC that is a fund of funds may have a controlling financial interest in one or more of the underlying funds in the same group of investment companies as the fund of funds.
In the circumstances of a feeder fund, generally, the staff has taken the position that the financial presentation that is most meaningful is unconsolidated, provided that, among other things: (i) the feeder fund attaches the financial statements of the master fund to its financial statements; (ii) if the master fund is organized as a partnership, the feeder fund separately discloses on its statement of operations the net investment income, the net realized gain or loss, and the net change in unrealized gain or loss allocated from the master fund; and (iii) if the master fund is organized as a partnership, the feeder fund includes the net investment income and expenses allocated from the master fund in its net investment income and expense ratios in its financial highlights. In the staff’s view, because a feeder fund typically is one of several investors in the master fund, such disclosure provides a meaningful and appropriately transparent presentation of the financial position and results of operations of the feeder fund.

In the circumstances of a fund of funds, generally, the staff has taken the position that the financial presentation that is most meaningful also is unconsolidated. A fund of funds typically invests in multiple underlying funds, may hold controlling financial interests in some underlying funds and non-controlling interests in other underlying funds, and the level of its interest in any particular underlying fund might fluctuate between controlling and non-controlling. In such circumstances, in the staff’s view, if the fund of funds were to consolidate the financial statements of certain of its underlying funds for certain periods, the resulting financial presentation may not be meaningful and may be confusing to the fund of funds’ investors. The staff notes, a fund of funds also should consider whether its investment in a single underlying fund is so significant to the fund of funds that its presentation of financial statements should be made in a manner similar to a master-feeder fund.

6 However, if the design and purpose of the master-feeder structure is for the master fund to be wholly owned by a sole feeder fund, the staff encourages registrants to consult with the staff on whether consolidated financial presentation would be the most meaningful.

7 See also SEC Staff Generic Comment Letter for Investment Company CFOs (Dec. 30, 1998)… indicating that: (1) a feeder fund’s shareholder report contains two sets of financial statements, one for the master fund and another for the feeder fund; and (2) in instances where the feeder fund and the master fund have different fiscal year-ends, the staff would not object if, at each feeder fund’s year-end, the audited shareholder report of the feeder fund is accompanied by the latest audited shareholder report of the master fund and by an unaudited balance sheet of the master fund and schedule of investments of the master fund as of the date of the feeder fund’s financial statements).

8-11 [Footnotes not shown]

12 See generally FASB ASC paragraph 946-210-45-7, and SEC Staff Generic Comment Letter for Investment Company CFOs (Nov. 7, 1997) …The staff notes that this consideration should be made regardless of whether the fund of funds has a controlling financial interest or a non-controlling interest in the underlying fund.

Feeder funds typically would not consolidate master funds in master-feeder structures and funds of funds typically would not consolidate investee funds.

F.3 Consolidation of investment companies

Excerpt from Accounting Standards Codification

Consolidation — Overall

Recognition — General

810-10-25-15

For the purposes of consolidating a subsidiary subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that subsidiary.
The scope exception with respect to investment companies applies only when the investment company itself is the reporting entity. That is, investment companies themselves may be subject to consolidation under the Variable Interest Model or Voting Model. Under the Variable Interest Model, a reporting entity investing in, or providing services to, an investment company must determine whether the investment company is a VIE, and, if so, whether it should consolidate the investment company as its primary beneficiary. However, in consolidation, a parent would retain its investment company subsidiary's accounting and disclosures for the underlying investments (e.g., fair value).

**Illustration F-2: Accounting for investments in an investment company**

Assume the same facts as in Illustration F-1, except that Investment company Z is a VIE and ABC, Inc. is the primary beneficiary. That is, ABC, Inc. is the parent of investment company Z. ABC, Inc. is not an investment company.

![Diagram showing the relationships between ABC, Inc., Investment company Z, Operating entity A, and Operating entity B.]

**Analysis**

Under the Variable Interest Model, ABC, Inc. would consolidate all of the assets and liabilities of Investment company Z but would recognize and retain the measurement basis of Investment company Z’s investments in the equity securities in Operating entities A and B at their fair values of $100 and $80, respectively.

If ABC, Inc. has a less than wholly owned interest in Investment company Z, it would allocate a portion of its earnings to noncontrolling interests.

If Investment company Z were not a VIE, ABC, Inc. would need to consider whether it controlled Investment company Z under the Voting Model.

See Section F.2 for guidance when an investment company controls another investment company.
Lot option contracts (Updated February 2016)

G.1 Introduction
Homebuilders commonly enter into lot option contracts, which may be variable interests under the Variable Interest Model. Accordingly, homebuilders must consider the provisions of the Variable Interest Model to determine whether the terms of a lot option contract may require consolidation of the landowning entity (i.e., the counterparty to the lot option contract).

This appendix summarizes the terms of typical structures of the entities homebuilders are involved with when they enter into lot option contracts to acquire raw land or finished lots and discusses the application of the Variable Interest Model to lot option contracts between homebuilders and landowning entities. While the discussion in this appendix covers structures commonly used by homebuilders to acquire finished lots, the purpose and design and the unique terms of each individual structure must be understood before applying ASC 810’s provisions. This appendix does not analyze the provisions of ASC 840-40, Leases – Sale-Leaseback Transactions, and ASC 470-40, Debt – Product Financing Arrangements, which in certain circumstances, must also be evaluated when a homebuilder concludes that it is not required to consolidate the landowning entity under the Variable Interest Model.

G.2 Background
Homebuilders frequently use lot option contracts to secure access to land to use in future construction of residential developments. In a lot option transaction, a landowner typically establishes a single member limited liability company (LLC) for the exclusive purpose of selling parcels of land to which it has title. The land owner may contribute the land and/or enter into a series of contracts to acquire and develop land after the LLC is formed. Lot option contracts are structured so that, in exchange for a deposit, the homebuilder has the option to purchase raw land or developed land at a future date at a fixed price.

An LLC is typically used because (1) it protects the homebuilder from the risk that an unincorporated landowner may file for bankruptcy and the bankruptcy court may prevent the homebuilder from purchasing the land (if the homebuilder wishes to exercise the lot option) and (2) it protects the landowner from certain legal risks. The only asset in the LLC may be the land subject to the purchase option. In addition, the LLC typically has no liabilities other than any deposit received, unless the land is subject to a nonrecourse mortgage.

Homebuilders use lot option contracts because they require a minimal capital investment and mitigate the risk associated with potential decreases in the value of land that may occur over the term of the lot option contract due to, among other things, market risk and risks of not receiving zoning, water rights, sewer or environmental approvals. The homebuilder’s primary economic risk related to a lot option contract is the loss of the deposit and any other due diligence and pre-acquisition costs incurred (if the lot option expires unexercised). Homebuilders generally believe that this risk is minor compared with the risk associated with ownership and potential decreases in the value of the land.

1 In certain lot option contracts, a homebuilder provides a letter of credit and no deposit. Because the member(s) of the LLC are protected from the first dollar risk of loss, the LLC generally would be a VIE. In addition to the member(s) interest in the LLC, the letter of credit provider (i.e., the homebuilder) is also a variable interest holder in the LLC.
G.3 Determining whether a homebuilder has a variable interest in the entity

Under the Variable Interest Model, all of the entity’s variable interests need to be identified, including those held by parties other than the reporting entity. Variable interests in an entity include equity interests, debt arrangements and guarantees. If a reporting entity determines that it has a variable interest in the entity, the reporting entity must evaluate the remaining provisions of the Variable Interest Model (i.e., whether the entity is a VIE and, if so, whether the reporting entity is the VIE’s primary beneficiary).

In a lot option contract, because the fixed price lot option absorbs the variability from changes in the value of the land, the homebuilder has a variable interest in the LLC even if the homebuilder provides no deposit. A lot option contract that is exercisable at fair value generally does not create a variable interest unless the homebuilder paid a deposit. A deposit is considered a variable interest.

In certain circumstances, the deposit is subject to a “free look” period (that is, unconditionally refundable for a specified period), which allows the homebuilder to perform its feasibility analysis and due diligence and to potentially walk away at any time during this period and receive a full refund of the deposit. In these circumstances, the homebuilder still has a variable interest in the LLC until the deposit is refunded.

G.3.1 Variable interests in specified assets

The Variable Interest Model also provides that, if a variable interest holder has an interest in a specified asset in a VIE, the interest may not be a variable interest. For example, a lot option contract that is for less than half of the total fair value of the LLC’s assets would not be considered a variable interest, unless the holder has another variable interest in the LLC as a whole (see more details in Section 5.5). If it is determined that the interest is not a variable interest, the related expected losses are not considered part of the expected losses of the LLC for purposes of determining the sufficiency of the equity at risk in the LLC.

To illustrate these concepts, consider an LLC that is capitalized with only land that is not subject to a mortgage. The LLC enters into a lot option contract with a homebuilder who pays a nonrefundable deposit. The homebuilder has a variable interest in a specified asset, and that asset is greater than half of the total fair value of the LLC’s assets. Accordingly, the homebuilder has a variable interest in the LLC.

Alternatively, assume that the LLC is capitalized with two tracts of land, Land A and Land B, whose fair values are 40% and 60%, respectively, of the total of the fair value of the LLC’s assets. If a homebuilder has a lot option contract with a nonrefundable deposit to acquire Land A, the homebuilder would not be considered to have a variable interest in the LLC. This is because Land A’s fair value is less than half of the total fair value of the LLC’s assets.

Even if the landowner must still perform significant work (e.g., land development) before the property is delivered, we believe the asset would be sufficiently “specified” such that the lot option contract needs to be evaluated as a variable interest in a potential VIE.

G.3.2 Other considerations

If the contractual arrangements between the homebuilder and the single member of the LLC call for the LLC to prepare the land for its intended use prior to lot takedowns, the risks associated with the costs of developing the land should be included when identifying the variable interests. If a homebuilder is responsible for developing the land on behalf of the LLC under a fixed fee arrangement with the LLC, the homebuilder would typically have a variable interest in the LLC.

If the homebuilder concludes that it does not hold any variable interests after evaluating the guidance in ASC 810, we believe that the homebuilder is not required to evaluate the provisions of the VIE model further.
G.4 Determining whether the entity is a VIE

The homebuilder should initially determine whether the LLC is a VIE on the date at which the homebuilder becomes involved with the LLC, which is generally when it enters into the lot option contract. The LLC is a VIE if any of the following conditions are met:

- The equity investment at risk is not sufficient to permit the LLC to finance its activities without additional subordinated financial support provided by any parties.
- As a group, the equity owners either (1) lack the power (through voting rights or similar rights) to direct the activities that most significantly affect the LLC’s economic performance, (2) are not obligated to absorb the LLC’s expected losses, or (3) do not have the right to receive the LLC’s expected residual returns.
- The LLC is established with non-substantive voting rights (i.e., an anti-abuse clause).

G.4.1 The entity does not have sufficient equity to finance its activities without additional subordinated financial support

For an entity not to be a VIE, the owners’ total equity investment at risk must be sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties. That is, the equity investment at risk must be greater than the expected losses of the entity. Only capital that is classified as equity in the entity’s financial statements may be considered at-risk equity.

As discussed above, in a typical lot option contract structure, the LLC is capitalized entirely with equity or with some combination of equity and nonrecourse debt. If the LLC is capitalized entirely with equity, the LLC has generally demonstrated that it can finance its activities without additional subordinated financial support. Additionally, if the LLC is capitalized with debt that is recourse only to the land and equity (i.e., nonrecourse to the single member of the LLC), the equity investment will also generally be determined to be sufficient, if that debt bears interest at a rate that suggests the lender is not absorbing the LLC’s expected losses. However, if the debt is subject to a guarantee or there are multiple classes of debt, additional evidence and professional judgment will be required to evaluate whether the LLC investment at risk is sufficient to permit the LLC to finance its activities without additional subordinated financial support.²

G.4.2 The equity holders, as a group, lack the characteristics of a controlling financial interest

For an entity not to be a VIE, the at-risk equity holders, as a group, must have all of the following characteristics of a controlling financial interest.

G.4.2.1 The power through voting rights or other rights to direct the activities on an entity that most significantly impact the entity’s economic performance

For an entity not to be a VIE, the holders of the equity investment at risk, as a group, must have the power (through voting or other rights), to direct the activities of an entity that most significantly affect the entity’s economic performance.

In a typical lot option contract structure, the single member of the LLC is typically the sole decision maker for deciding (1) the capital structure (e.g., number of investors, capital requirements, allocation of

² Certain lot option contracts between the homebuilder and the member(s) of the LLC call for the LLC to prepare the land for its intended use. The costs of developing the land should be included in the analysis of sufficiency of equity investment at risk to determine whether the LLC is a VIE.
Lot option contracts (Updated February 2016)

**Financial reporting developments**

Consolidation and the Variable Interest Model | G-4

profits and losses) of the LLC, (2) the assets to be included in the LLC, including acquisition or disposition of those assets, (3) the terms of any financing, including whether to refinance any debt and (4) how the entity is operated (e.g., approval of operating budgets). The homebuilder typically does not have any decision-making ability over the LLC’s activities, and while it may have certain protective rights pursuant to the lot option contract, the homebuilder typically does not have substantive participating or kick out rights, as they are defined in ASC 810-10-25.

Accordingly, the holder of the equity investment at risk in a typical LLC structure will generally have the power to direct the activities that most significantly affect the entity's economic performance. This determination should be made, however, after consideration of all of the individual facts and circumstances (e.g., considering the LLC's purpose and design). Additionally, if the LLC has more than one member, it would be important to consider whether the LLC has the characteristics of a partnership or corporation and which provisions of the Variable Interest Model to apply to determine whether the LLC is a VIE.

**G.4.2.2 Obligation to absorb the entity's expected losses**

As a group, the holders of the equity investments at risk must have the obligation to absorb the expected losses of an entity for the entity not to be a VIE. Expected losses of the LLC will generally arise from a decline in the value of the assets (e.g., market demand may drop). While the single member of the LLC is exposed to these expected losses through its equity interest, the homebuilder’s deposit provides the single member of the LLC with first dollar risk of loss protection; therefore, the LLC generally will be a VIE.

If the contractual arrangements between the homebuilder and the single member of the LLC calls for the LLC to prepare the land for its intended use prior to lot takedowns, the risks associated with the costs of developing the land should be included in the assessment of whether the LLC is a VIE. The contractual arrangements typically specify which party bears the risk of development cost overruns or receives the benefits of the development cost efficiencies. For example, if the homebuilder is responsible for developing the land under a fixed fee arrangement with the LLC, the risk of cost overruns is borne by the homebuilder, and not through the equity investments at risk.

**G.4.2.3 Right to receive the entity’s expected residual returns**

The Variable Interest Model requires that the equity holders, as a group, must have the right to receive the expected residual returns of the entity for the entity not to be a VIE. The equity holders cannot have their return capped through arrangements with the entity, with other variable interest holders, or by the entity’s governing documents. In applying this provision to a typical lot option contract structure used in the homebuilder industry, if the LLC writes a fixed-price call option on its only asset, by design, the lot option contract would cap the return of the equity holders. As a result, the LLC would be a VIE. However, if the lot option contract is exercisable at fair value, the lot option contract would not cap the equity holders’ returns and the LLC would not fail this criterion.

**G.4.3 Entity established with non-substantive voting rights**

The last criterion to consider when evaluating whether an entity is a VIE is whether the entity was established with non-substantive voting rights (i.e., the anti-abuse test). The purpose of this test is to prevent a reporting entity from avoiding consolidation of an entity by organizing the entity with non-substantive voting interests.

Under this test, an entity is a VIE if (1) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their right to receive the expected residual returns or both and (2) substantially all of the legal entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights, including its related parties and certain de facto agents. Both criteria need to be met.

A lot option contract absorbs a portion of the variability resulting from changes in the fair value of land
held by the entity. As a result, the voting rights of the lot option holder are disproportionately fewer than its obligation to absorb expected losses and right to receive residual returns of the entity. However, the activities of the LLC generally are not conducted on behalf of the option holder (i.e., the activities are conducted on behalf of the single member of the LLC), thus the second criterion is not met\(^3\) and the LLC would not be a VIE.

**G.5 Determining whether the homebuilder is the primary beneficiary**

In many circumstances, the reporting entity would conclude that the single member LLC is not a VIE. However, in other instances (e.g., the lot option contract exercisable at a fixed price), the LLC is a VIE and the homebuilder must evaluate whether it consolidates the LLC.

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 (power) and (2) the obligation to absorb losses or the right to receive benefits from the VIE that could potentially be significant to the VIE (benefits). Under ASC 810, the primary beneficiary analysis is a qualitative assessment based on power and benefits and considers the purpose and design of the entity.

**G.5.1 Power**

To evaluate the power criterion, homebuilders need to qualitatively assess which party (if any) has the power through its variable interest(s) to direct the activities that most significantly affect the VIE’s economic performance. In performing the primary beneficiary determination, it is important to consider the purpose and design of the LLC. While some LLCs may have a limited number of decisions that would be considered significant, we believe that virtually all entities have some level of decision making upon which to base the analysis of power. As such, we believe that few entities are on “auto-pilot.”

For example, some activities that may significantly affect the economic performance of the LLC could include decisions about the capital structure of the LLC, which assets are included in the LLC, decisions about the LLC’s financing and how is operated. In addition, it is important to note that, in some cases, the LLC may be using the property that is the subject of the lot option contract in current revenue-generating activities. In those cases, it would seem appropriate to consider the operating activities of the LLC in identifying the decisions that would comprise the elements of power. After the activities that represent power have been identified, the homebuilder should evaluate whether it has the power to direct those activities. In typical lot option contracts, the homebuilder generally does not have the power to direct the activities that most significantly impact the economic performance of the LLC, and hence, would not be the primary beneficiary.

**G.5.2 Benefits**

If the power criterion is met, homebuilders will need to determine whether they also have benefits. In a typical fixed-price lot option contract, the homebuilder will benefit from increases in fair value in excess of the contracted purchase price under the agreement through its variable interest. Therefore, the homebuilder will satisfy the benefits criterion. If so, the homebuilder would consolidate the LLC.

As noted above, we understand that the terms and conditions of lot option contracts vary. Therefore, a careful analysis of the individual facts and circumstances of each of the arrangements and the rights and obligations transferred to the homebuilder is necessary in order to determine whether the homebuilder is the primary beneficiary.

---

\(^3\) This analysis assumes that the lot option holder and single member of the LLC are not related parties.
G.6  **Reconsideration events**

A homebuilder should evaluate its lot option contract pursuant to the Variable Interest Model at the inception of the arrangement based on the contractual arrangements as of that date. Each subsequent amendment of the contractual arrangements between the homebuilder and the landowner would be a contractual change among the parties that would generally require reconsideration of whether the LLC is a VIE and may affect the determination of the primary beneficiary.

We believe the exercise or expiration of the lot option contract represents a contractual change among the parties that requires reconsideration of whether the LLC is a VIE. We also believe that if the homebuilder sells its lot option contract to an unrelated party or otherwise disposes of its lot option contract to an unrelated party, the homebuilder may no longer have a variable interest in the LLC. Without a variable interest in the LLC, the homebuilder could not be the primary beneficiary and, therefore, could not consolidate the LLC.

Some lot option contracts require that a homebuilder make additional deposits (deposits in addition to a nominal deposit made at inception of the arrangement) as development targets are met by the seller (e.g., approval of tentative map, zoning). We do not believe a requirement to make additional deposits constitutes a change in the contractual arrangements among the parties that requires a reevaluation of whether the LLC is a VIE. This is because the initial assessment of expected losses and expected residual returns to determine whether the LLC has sufficient equity at risk should consider all of the potential outcomes of the LLC.

Further, some lot option contracts call for the homebuilder’s deposit to be applied against lot takedowns (i.e., each lot option exercised reduces the amount of deposit outstanding). If a reconsideration event occurs, the homeowner would consider as its variable interest the fair value of the remaining deposit (rather than the original deposit).

G.7  **Recognition and measurement**

If a homebuilder is determined to be the primary beneficiary of an LLC, it should initially measure the assets, liabilities and noncontrolling interests of the newly consolidated LLC consistent with the requirements for business combinations described in ASC 805 at the date the reporting entity first becomes the primary beneficiary. After the initial measurement, the assets, liabilities, noncontrolling interests, results of operations (if any) and cash flows of a consolidated LLC should be accounted for pursuant to the general consolidation procedure guidance in ASC 810-10. In addition, the homebuilder should present separately on the face of the statement of financial position (1) assets of a consolidated LLC that can be used only to settle obligations of the consolidated LLC and (2) liabilities of a consolidated LLC for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

G.8  **Disclosures**

The Variable Interest Model requires disclosures by reporting entities with variable interests in VIEs, regardless of whether the VIE is consolidated. Therefore, even if the homebuilder is not the primary beneficiary of a LLC, it may be required to provide disclosures specified in the Variable Interest Model.
### Abbreviations used in this publication

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>FASB Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 250</td>
<td>FASB ASC Topic 250, Accounting Changes and Error Corrections</td>
</tr>
<tr>
<td>ASC 320</td>
<td>FASB ASC Topic 320, Investments – Debt and Equity Securities</td>
</tr>
<tr>
<td>ASC 323</td>
<td>FASB ASC Topic 323, Investments – Equity Method and Joint Ventures</td>
</tr>
<tr>
<td>ASC 350</td>
<td>FASB ASC Topic 350, Intangibles – Goodwill and Other</td>
</tr>
<tr>
<td>ASC 360</td>
<td>FASB ASC Topic 360, Property, Plant, and Equipment</td>
</tr>
<tr>
<td>ASC 470</td>
<td>FASB ASC Topic 470, Debt</td>
</tr>
<tr>
<td>ASC 480</td>
<td>FASB ASC Topic 480, Distinguishing Liabilities from Equity</td>
</tr>
<tr>
<td>ASC 605</td>
<td>FASB ASC Topic 605, Revenue Recognition</td>
</tr>
<tr>
<td>ASC 710</td>
<td>FASB ASC Topic 710, Compensation – General</td>
</tr>
<tr>
<td>ASC 712</td>
<td>FASB ASC Topic 712, Compensation – Nonretirement Postemployment Benefits</td>
</tr>
<tr>
<td>ASC 715</td>
<td>FASB ASC Topic 715, Compensation – Retirement Benefits</td>
</tr>
<tr>
<td>ASC 718</td>
<td>FASB ASC Topic 718, Compensation – Stock Compensation</td>
</tr>
<tr>
<td>ASC 805</td>
<td>FASB ASC Topic 805, Business Combinations</td>
</tr>
<tr>
<td>ASC 808</td>
<td>FASB ASC Topic 808, Collaborative Arrangements</td>
</tr>
<tr>
<td>ASC 810</td>
<td>FASB ASC Topic 810, Consolidation</td>
</tr>
<tr>
<td>ASC 815</td>
<td>FASB ASC Topic 815, Derivatives and Hedging</td>
</tr>
<tr>
<td>ASC 820</td>
<td>FASB ASC Topic 820, Fair Value Measurements and Disclosures</td>
</tr>
<tr>
<td>ASC 825</td>
<td>FASB ASC Topic 825, Financial Instruments</td>
</tr>
<tr>
<td>ASC 840</td>
<td>FASB ASC Topic 840, Leases</td>
</tr>
<tr>
<td>ASC 850</td>
<td>FASB ASC Topic 850, Related Party Disclosures</td>
</tr>
<tr>
<td>ASC 860</td>
<td>FASB ASC Topic 860, Transfers and Servicing</td>
</tr>
<tr>
<td>ASC 940</td>
<td>FASB ASC Topic 940, Financial Services – Broker and Dealers</td>
</tr>
<tr>
<td>ASC 944</td>
<td>FASB ASC Topic 944, Financial Services – Insurance</td>
</tr>
<tr>
<td>ASC 946</td>
<td>FASB ASC Topic 946, Financial Services – Investment Companies</td>
</tr>
<tr>
<td>ASC 958</td>
<td>FASB ASC Topic 958, Not-for-Profit Entities</td>
</tr>
<tr>
<td>ASC 960</td>
<td>FASB ASC Topic 960, Plan Accounting – Defined Benefit Pension Plans</td>
</tr>
<tr>
<td>ASC 976</td>
<td>FASB ASC Topic 976, Real Estate – Retail Land</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Other authoritative standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASR 268</td>
<td>SEC Accounting Series Release No. 268, Presentation in Financial Statements of Redeemable Preferred Stock</td>
</tr>
<tr>
<td>GASB 20</td>
<td>Governmental Accounting Standards Board Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting</td>
</tr>
<tr>
<td>FR-67</td>
<td>SEC Final Rule 67, Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations</td>
</tr>
<tr>
<td>ASU 2009-17</td>
<td>Accounting Standards Update No. 2009-17, Consolidation (Topic 810): Improvements to Financial Reporting by Reporting entities Involved with Variable Interest Entities</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Other authoritative standards</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td></td>
<td><strong>Interest Entities</strong></td>
</tr>
<tr>
<td>ASU 2013-08</td>
<td>Accounting Standards Update No. 2013-08, Financial Services – Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements</td>
</tr>
<tr>
<td>ASU 2013-12</td>
<td>Accounting Standards Update No. 2013-12, Definition of a Public Business Entity—An Addition to the Master Glossary</td>
</tr>
<tr>
<td>ASU 2014-01</td>
<td>Accounting Standards Update No. 2014-01, Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)</td>
</tr>
<tr>
<td>ASU 2014-07</td>
<td>Accounting Standards Update No. 2014-07, Consolidation (Topic 810), Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, a consensus of the Private Company Council</td>
</tr>
<tr>
<td>ASU 2014-11</td>
<td>Accounting Standards Update No. 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures</td>
</tr>
<tr>
<td>ASU 2015-02</td>
<td>Accounting Standards Update No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis</td>
</tr>
<tr>
<td></td>
<td><strong>Non-authoritative standards</strong></td>
</tr>
<tr>
<td>EITF 02-5</td>
<td>EITF Issue No. 02-5, Definition of “Common Control” in Relation to FASB Statement No. 141</td>
</tr>
<tr>
<td>FIN 46</td>
<td>FASB Interpretation No. 46, Consolidation of Variable Interest Entities—an interpretation of ARB No. 51</td>
</tr>
<tr>
<td>FIN 46(R)</td>
<td>FASB Interpretation No. 46 (Revised), Consolidation of Variable Interest Entities—an interpretation of ARB No. 51</td>
</tr>
<tr>
<td>FR 67</td>
<td>SEC Final Rule 67, Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations</td>
</tr>
<tr>
<td>FSP FIN 46(R)-3</td>
<td>FASB Staff Position FIN 46(R)-3, Evaluating Whether, as a Group, the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity’s Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46</td>
</tr>
<tr>
<td>Issue E22</td>
<td>Statement 133 Implementation Issue No. E22, Accounting for the Discontinuance of Hedging Relationships Arising from Changes in Consolidation Practices Related to Applying FASB Interpretation No. 46 or 46(R)</td>
</tr>
<tr>
<td>FAS 133</td>
<td>FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities</td>
</tr>
<tr>
<td>FAS 167</td>
<td>FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R)</td>
</tr>
</tbody>
</table>
## Index of ASC references in this publication

<table>
<thead>
<tr>
<th>ASC paragraph</th>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>272-10-05-2 through 05-4</td>
<td>7.3.1.6</td>
<td>Limited liability companies</td>
</tr>
<tr>
<td>323-10</td>
<td>14.2.3</td>
<td>Initial measurement when a reporting entity deconsolidates an entity</td>
</tr>
<tr>
<td>323-10-20</td>
<td>1.2.2</td>
<td>Step 2. Does a scope exception to the Variable Interest Model apply?</td>
</tr>
<tr>
<td>323-10-20</td>
<td>4.4.4.2.1</td>
<td>Determining whether an entity is a joint venture</td>
</tr>
<tr>
<td>323-30-15-3</td>
<td>4.4.4.2.1</td>
<td>Determining whether an entity is a joint venture</td>
</tr>
<tr>
<td>323-30-35-3</td>
<td>7.3.1.6</td>
<td>Limited liability companies</td>
</tr>
<tr>
<td>323-30-15-3</td>
<td>4.4.4.2.1</td>
<td>Determining whether an entity is a joint venture</td>
</tr>
<tr>
<td>323-740-05-02 through 05-03</td>
<td>B.1</td>
<td>Summary of tax credit</td>
</tr>
<tr>
<td>360-20</td>
<td>5.4.10</td>
<td>Purchase and sale contracts for real estate</td>
</tr>
<tr>
<td>360-20</td>
<td>D.1</td>
<td>Overview and scope</td>
</tr>
<tr>
<td>360-20-40-5</td>
<td>5.4.10</td>
<td>Purchase and sale contracts for real estate</td>
</tr>
<tr>
<td>470-40</td>
<td>5.2.2.1</td>
<td>Consideration 1: Which variable interests absorb the variability designated in Step 1?</td>
</tr>
<tr>
<td>605-45</td>
<td>9.5.1</td>
<td>Principal-agency relationship</td>
</tr>
<tr>
<td>710-10-45-1</td>
<td>4.3.1.3</td>
<td>Deferred compensation trusts (e.g., a rabbi trust)</td>
</tr>
<tr>
<td>710-10-45-1</td>
<td>C.1.2</td>
<td>Scope of the voting interest entity model</td>
</tr>
<tr>
<td>805-20-25</td>
<td>12.4</td>
<td>Primary beneficiary of a VIE that is not a business</td>
</tr>
<tr>
<td>805-20-30</td>
<td>12.4</td>
<td>Primary beneficiary of a VIE that is not a business</td>
</tr>
<tr>
<td>805-30-25-5</td>
<td>12.4.1</td>
<td>Contingent consideration in an asset acquisition when the entity is a VIE that does not constitute a business</td>
</tr>
<tr>
<td>805-30-25-7</td>
<td>12.4.1</td>
<td>Contingent consideration in an asset acquisition when the entity is a VIE that does not constitute a business</td>
</tr>
<tr>
<td>805-50</td>
<td>2.3</td>
<td>Common control</td>
</tr>
<tr>
<td>805-50</td>
<td>12.4</td>
<td>Primary beneficiary of a VIE that is not a business</td>
</tr>
<tr>
<td>805-50-15-4</td>
<td>12.4</td>
<td>Primary beneficiary of a VIE that is not a business</td>
</tr>
<tr>
<td>805-50-15-6</td>
<td>2.3</td>
<td>Common control</td>
</tr>
<tr>
<td>805-50-30-5</td>
<td>12.2</td>
<td>Primary beneficiary and VIE are under common control</td>
</tr>
<tr>
<td>805-50-30-5</td>
<td>12.4</td>
<td>Primary beneficiary of a VIE that is not a business</td>
</tr>
<tr>
<td>810-10-10-1</td>
<td>2.2</td>
<td>Controlling financial interest</td>
</tr>
<tr>
<td>810-10-15-3 through 15-4</td>
<td>4.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>810-10-15-3</td>
<td>C.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>810-10-15-5 through 15-6</td>
<td>C.1.2</td>
<td>Scope of the voting interest entity model</td>
</tr>
<tr>
<td>810-10-15-8</td>
<td>2.2</td>
<td>Controlling financial interest</td>
</tr>
<tr>
<td>810-10-15-8</td>
<td>4.4.1</td>
<td>Not-for-profit organizations</td>
</tr>
<tr>
<td>810-10-15-8 through 15-9</td>
<td>C.2.1</td>
<td>Voting Model: Consolidation of corporations</td>
</tr>
<tr>
<td><strong>ASC paragraph</strong></td>
<td><strong>Section</strong></td>
<td></td>
</tr>
<tr>
<td>------------------</td>
<td>------------</td>
<td></td>
</tr>
<tr>
<td>810-10-15-8</td>
<td>C2.1.1</td>
<td></td>
</tr>
<tr>
<td>810-10-15-8A</td>
<td>7.3.1.3.2</td>
<td></td>
</tr>
<tr>
<td>810-10-15-9</td>
<td>4.2.4</td>
<td></td>
</tr>
<tr>
<td>810-10-15-10</td>
<td>C.3</td>
<td></td>
</tr>
<tr>
<td>810-10-15-10(a)(1)(iii)</td>
<td>C.3.1</td>
<td></td>
</tr>
<tr>
<td>810-10-15-12</td>
<td>4.3</td>
<td></td>
</tr>
<tr>
<td>810-10-15-12(d)</td>
<td>F.2</td>
<td></td>
</tr>
<tr>
<td>810-10-15-12(f)</td>
<td>4.3.4</td>
<td></td>
</tr>
<tr>
<td>810-10-15-13</td>
<td>4.4</td>
<td></td>
</tr>
<tr>
<td>810-10-15-13A through 13B</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14</td>
<td>7.2</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)</td>
<td>5.2.1.2.3</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)</td>
<td>5.5</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)</td>
<td>7.2.2</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)</td>
<td>7.2.2.3</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)</td>
<td>7.2.2.5</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)</td>
<td>7.2.3.4</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)</td>
<td>7.3.1.3.2</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a) through 14(b)</td>
<td>7.3.1.3.2</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)</td>
<td>B.2</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)(3)</td>
<td>4.3.1.3</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(a)(3) through 14(a)(4)</td>
<td>7.2.2.4</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(b)</td>
<td>7.3.3</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(b)(1)</td>
<td>7.3.1.3.4</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(b)(1)</td>
<td>7.3.1.4</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(b)(1)(i)</td>
<td>7.3.1.5</td>
<td></td>
</tr>
<tr>
<td>810-10-15-14(b)(1)(i)</td>
<td>7.3.1.3.1</td>
<td></td>
</tr>
</tbody>
</table>

- **Consolidation of a not-for-profit organization other than a partnership**
- **Limited partnerships and similar entities**
- **Majority-owned entities**
- **Scope of the voting interest entity model**
- **Exceptions to consolidation by a reporting entity holding a majority of voting stock or limited partnership interests**
- **Foreign currency exchange restrictions**
- **Scope exceptions to consolidation guidance**
- **Consolidation by an investment company**
- **Money market funds**
- **Scope exceptions to the Variable Interest Model**
- **Consideration of substantive terms, transactions and arrangements**
- **Evaluating disproportionate power and benefits**
- **The entity does not have enough equity to finance its activities without additional subordinated financial support**
- **The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance**
- **Entity established with non-substantive voting rights**
- **Subordination**
- **Variable interests in specified assets**
- **Determining whether an equity investment is at risk**
- **Amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity**
- **Other examples of determining equity investments at risk**
- **The amount of equity invested in the entity exceeds the estimate of the entity’s expected losses based on reasonable quantitative evidence**
- **Limited partnerships and similar entities**
- **Summary of the investment**
- **Deferred compensation trusts (e.g., a rabbi trust)**
- **Amounts financed for the equity holder directly by the entity or by other parties involved with the entity**
- **Right to receive an entity’s expected residual returns**
- **Participating rights**
- **Effect of decision makers or service providers when evaluating ASC 810-10-15-14(b)(1)(i)**
- **Franchise arrangements when evaluating ASC 810-10-15-14(b)(1)**
- **Corporations and similar entities**
<table>
<thead>
<tr>
<th>ASC paragraph</th>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>810-10-15-14(b)(2)</td>
<td>7.3.2</td>
<td>Obligation to absorb an entity’s expected losses</td>
</tr>
<tr>
<td>810-10-15-14(b)(2)</td>
<td>7.3.2.1</td>
<td>Common arrangements that may protect equity investments at risk from absorbing losses</td>
</tr>
<tr>
<td>810-10-15-14(b)(2)</td>
<td>7.3.2.2</td>
<td>Disproportionate sharing of losses</td>
</tr>
<tr>
<td>810-10-15-14(b)(2)</td>
<td>7.3.2.3</td>
<td>Variable interests in specified assets or silos</td>
</tr>
<tr>
<td>810-10-15-14(b)(2)</td>
<td>7.3.2.4</td>
<td>Illustrative examples</td>
</tr>
<tr>
<td>810-10-15-14(b)(2)</td>
<td>7.3.3.2</td>
<td>Variable interests in specified assets or silos</td>
</tr>
<tr>
<td>810-10-15-14(b)(2)</td>
<td>B.2</td>
<td>Summary of the investment</td>
</tr>
<tr>
<td>810-10-15-14(b)(3)</td>
<td>7.3.3.1</td>
<td>Disproportionate sharing of profits</td>
</tr>
<tr>
<td>810-10-15-14(b)(3)</td>
<td>7.3.3.3</td>
<td>Illustrative examples</td>
</tr>
<tr>
<td>810-10-15-14(c)</td>
<td>7.4.1</td>
<td>Condition 1: Disproportionate votes to economics</td>
</tr>
<tr>
<td>810-10-15-14(c)</td>
<td>7.4.2</td>
<td>Condition 2: Substantially all of an entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights</td>
</tr>
<tr>
<td>810-10-15-14(c)</td>
<td>8.3.2</td>
<td>Evaluating disproportionate power and benefits</td>
</tr>
<tr>
<td>810-10-15-14(c)(2)</td>
<td>9.2</td>
<td>Single decision maker</td>
</tr>
<tr>
<td>810-10-15-15</td>
<td>4.2.2</td>
<td>Portions of entities</td>
</tr>
<tr>
<td>810-10-15-17</td>
<td>4.4</td>
<td>Scope exceptions to the Variable Interest Model</td>
</tr>
<tr>
<td>810-10-15-17(d)</td>
<td>4.4.4</td>
<td>Business scope exception</td>
</tr>
<tr>
<td>810-10-15-17A through 17C</td>
<td>D.1</td>
<td>Overview and scope</td>
</tr>
<tr>
<td>810-10-15-17D</td>
<td>E.2</td>
<td>Scope</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.1</td>
<td>Legal entity</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.4</td>
<td>Decision maker and decision-making authority</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.6</td>
<td>Expected losses, expected residual returns and expected variability</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.8</td>
<td>Kick-out rights and liquidation rights</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.9</td>
<td>Participating rights</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.10</td>
<td>Protective rights</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.11</td>
<td>Primary beneficiary</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.12</td>
<td>Related parties and de facto agents</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.13</td>
<td>Subordinated financial support</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.14</td>
<td>Variable interest entity</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.15</td>
<td>Variable interests</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.16</td>
<td>Collateralized financing entity</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.18</td>
<td>Private company</td>
</tr>
<tr>
<td>810-10-20</td>
<td>2.19</td>
<td>Public business entity</td>
</tr>
<tr>
<td>810-10-20</td>
<td>7.3.1.3.3</td>
<td>Kick-out rights</td>
</tr>
<tr>
<td>810-10-20</td>
<td>7.3.1.3.4</td>
<td>Participating rights</td>
</tr>
<tr>
<td>810-10-20</td>
<td>7.3.1.3.5</td>
<td>Protective rights</td>
</tr>
<tr>
<td>810-10-20</td>
<td>12.5</td>
<td>Primary beneficiary of a VIE that is a collateralized financing entity</td>
</tr>
<tr>
<td>810-10-20</td>
<td>A.2</td>
<td>Expected losses, expected residual returns and expected variability</td>
</tr>
<tr>
<td>ASC paragraph</td>
<td>Section</td>
<td>Content Description</td>
</tr>
<tr>
<td>-----------------</td>
<td>----------------------------------------------</td>
<td>----------------------------------------------------------</td>
</tr>
<tr>
<td>810-10-20</td>
<td>C.2.2</td>
<td>Voting Model: Control of limited partnerships and similar entities</td>
</tr>
<tr>
<td>810-10-20</td>
<td>C.3.2.1</td>
<td>Participating rights</td>
</tr>
<tr>
<td>810-10-20</td>
<td>C.3.2.2</td>
<td>Protective rights</td>
</tr>
<tr>
<td>810-10-25-1</td>
<td>C.2.1</td>
<td>Voting Model: Consolidation of corporations</td>
</tr>
<tr>
<td>810-10-25-1A</td>
<td>C.2.2</td>
<td>Voting Model: Control of limited partnerships and similar entities</td>
</tr>
<tr>
<td>810-10-25-2</td>
<td>C.3.2</td>
<td>Evaluating the effect of noncontrolling rights</td>
</tr>
<tr>
<td>810-10-25-3</td>
<td>C.3.2</td>
<td>Evaluating the effect of noncontrolling rights</td>
</tr>
<tr>
<td>810-10-25-5</td>
<td>C.3.2</td>
<td>Evaluating the effect of noncontrolling rights</td>
</tr>
<tr>
<td>810-10-25-6 through 25-8</td>
<td>C.3.2.1</td>
<td>Participating rights</td>
</tr>
<tr>
<td>810-10-25-7</td>
<td>C.3.2.2</td>
<td>Protective rights</td>
</tr>
<tr>
<td>810-10-25-10</td>
<td>7.3.1.3.5</td>
<td>Protective rights</td>
</tr>
<tr>
<td>810-10-25-10</td>
<td>C.3.2.2</td>
<td>Protective rights</td>
</tr>
<tr>
<td>810-10-25-11 through 25-12</td>
<td>C.3.2.1</td>
<td>Participating rights</td>
</tr>
<tr>
<td>810-10-25-13</td>
<td>C.3.2.1.1</td>
<td>Evaluating the substance of noncontrolling rights</td>
</tr>
<tr>
<td>810-10-25-14</td>
<td>C.3.2</td>
<td>Evaluating the effect of noncontrolling rights</td>
</tr>
<tr>
<td>810-10-25-14A through C</td>
<td>7.3.1.3.3</td>
<td>Kick-out rights</td>
</tr>
<tr>
<td>810-10-25-15</td>
<td>F.3</td>
<td>Consolidation of investment companies</td>
</tr>
<tr>
<td>810-10-25-21</td>
<td>5.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>810-10-25-22</td>
<td>5.2</td>
<td>Step-by-step approach to identifying variable interests</td>
</tr>
<tr>
<td>810-10-25-23</td>
<td>5.2.2</td>
<td>Step 2: Identify variable interests</td>
</tr>
<tr>
<td>810-10-25-24</td>
<td>5.2.1.2</td>
<td>Consideration 2: What is the nature of the risks in the entity?</td>
</tr>
<tr>
<td>810-10-25-25 through 25-27</td>
<td>5.2.1.1</td>
<td>Consideration 1: What is the purpose for which the entity was created?</td>
</tr>
<tr>
<td>810-10-25-29</td>
<td>5.2.1</td>
<td>Step 1: Determine the variability an entity was designed to create and distribute</td>
</tr>
<tr>
<td>810-10-25-31</td>
<td>5.2.1.2.2</td>
<td>Terms of interests issued</td>
</tr>
<tr>
<td>810-10-25-32</td>
<td>5.2.1.2.3</td>
<td>Subordination</td>
</tr>
<tr>
<td>810-10-25-33</td>
<td>5.2.1.2.1</td>
<td>Certain interest rate risk</td>
</tr>
<tr>
<td>810-10-25-33</td>
<td>A.6.1.3</td>
<td>Cash flow prime method</td>
</tr>
<tr>
<td>810-10-25-34 through 25-36</td>
<td>5.4.4</td>
<td>Derivative instruments</td>
</tr>
<tr>
<td>810-10-25-35 through 25-36</td>
<td>5.4.4.1</td>
<td>Common derivative contracts</td>
</tr>
<tr>
<td>810-10-25-35 through 25-36</td>
<td>5.4.4.3</td>
<td>Total return swaps</td>
</tr>
<tr>
<td>810-10-25-35 through 25-36</td>
<td>5.4.6</td>
<td>Purchase and supply contracts</td>
</tr>
<tr>
<td>810-10-25-35 through 25-36</td>
<td>5.4.7</td>
<td>Operating leases</td>
</tr>
<tr>
<td>810-10-25-35 through 25-36</td>
<td>5.4.11</td>
<td>Netting or offsetting contracts</td>
</tr>
<tr>
<td>810-10-25-37</td>
<td>7.5</td>
<td>Initial determination of VIE status</td>
</tr>
<tr>
<td>810-10-25-38</td>
<td>8.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>810-10-25-38A through 38J</td>
<td>5.4.13</td>
<td>Fees paid to decision makers or service providers</td>
</tr>
<tr>
<td>810-10-25-38A through 38J</td>
<td>8.3</td>
<td>Benefits</td>
</tr>
<tr>
<td>810-10-25-38A through 38J</td>
<td>8.4</td>
<td>Other frequently asked questions</td>
</tr>
<tr>
<td>ASC paragraph</td>
<td>Section</td>
<td>Description</td>
</tr>
<tr>
<td>---------------------</td>
<td>--------------------------</td>
<td>------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>810-10-25-38B</td>
<td>8.2.2</td>
<td>Step 2: Identify the activities that most significantly impact the VIE’s economic performance</td>
</tr>
<tr>
<td>810-10-25-38C</td>
<td>8.2.4</td>
<td>Kick-out rights, participating rights and protective rights</td>
</tr>
<tr>
<td>810-10-25-38C</td>
<td>8.2.4.1</td>
<td>Kick-out rights</td>
</tr>
<tr>
<td>810-10-25-38D</td>
<td>8.2.3.3</td>
<td>Shared power</td>
</tr>
<tr>
<td>810-10-25-38E</td>
<td>8.2.3</td>
<td>Steps 3 and 4: Identify how decisions about significant activities are made and the party or parties that make them</td>
</tr>
<tr>
<td>810-10-25-38E</td>
<td>8.2.3.6</td>
<td>Multiple unrelated parties direct different activities that most significantly impact the VIE’s economic performance</td>
</tr>
<tr>
<td>810-10-25-38F</td>
<td>8.2.1.1</td>
<td>Involvement with the design of the VIE</td>
</tr>
<tr>
<td>810-10-25-38G</td>
<td>8.3.2</td>
<td>Evaluating disproportionate power and benefits</td>
</tr>
<tr>
<td>810-10-25-38H through 38J</td>
<td>8.3.1</td>
<td>Fees paid to decision makers or service providers</td>
</tr>
<tr>
<td>810-10-25-38H</td>
<td>8.3</td>
<td>Primary beneficiary considerations</td>
</tr>
<tr>
<td>810-10-25-42</td>
<td>9.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>810-10-25-43</td>
<td>2.12</td>
<td>Related parties and de facto agents</td>
</tr>
<tr>
<td>810-10-25-43</td>
<td>7.4.2</td>
<td>Condition 2: Substantially all of an entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights</td>
</tr>
<tr>
<td>810-10-25-43</td>
<td>7.4.3</td>
<td>Related party and de facto agent considerations</td>
</tr>
<tr>
<td>810-10-25-43</td>
<td>9.5.1</td>
<td>Principal-agency relationship</td>
</tr>
<tr>
<td>810-10-25-43</td>
<td>10.2</td>
<td>De facto agents</td>
</tr>
<tr>
<td>810-10-25-43</td>
<td>10.2.3</td>
<td>Separate accounts of insurance enterprises as potential related parties</td>
</tr>
<tr>
<td>810-10-25-43(d)</td>
<td>4.4.4.2</td>
<td>Significant participation in the design or redesign of an entity</td>
</tr>
<tr>
<td>810-10-25-43(d)</td>
<td>7.4.3</td>
<td>Related party and de facto agent considerations</td>
</tr>
<tr>
<td>810-10-25-44</td>
<td>8.2.3</td>
<td>Steps 3 and 4: Identify how decisions about significant activities are made and the party or parties that make them</td>
</tr>
<tr>
<td>810-10-25-44</td>
<td>9.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>810-10-25-44</td>
<td>9.5</td>
<td>Determining which party is most closely associated with a VIE</td>
</tr>
<tr>
<td>810-10-25-44</td>
<td>9.5.2</td>
<td>Relationship and significance of a VIE's activities to members of a related party group</td>
</tr>
<tr>
<td>810-10-25-44</td>
<td>9.5.3</td>
<td>Exposure to variability associated with the anticipated economic performance of the VIE</td>
</tr>
<tr>
<td>810-10-25-44</td>
<td>9.6</td>
<td>One member of a related party group not clearly identified</td>
</tr>
<tr>
<td>810-10-25-45 through 25-47</td>
<td>7.2.3</td>
<td>Methods for determining whether an equity investment at risk is sufficient</td>
</tr>
<tr>
<td>810-10-25-45</td>
<td>7.2.3.1</td>
<td>10% test – a misnomer</td>
</tr>
<tr>
<td>810-10-25-45</td>
<td>7.2.3.5</td>
<td>Illustrative examples</td>
</tr>
<tr>
<td>810-10-25-45(a)</td>
<td>7.2.3.2</td>
<td>The entity can finance its activities without additional subordinated financial support</td>
</tr>
<tr>
<td>ASC paragraph</td>
<td>Section</td>
<td>Description</td>
</tr>
<tr>
<td>-------------------</td>
<td>---------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>810-10-25-46</td>
<td>7.2.3.5</td>
<td>Illustrative examples</td>
</tr>
<tr>
<td>810-10-25-48</td>
<td>D.8</td>
<td>Elimination of implicit variable interest guidance applicable to all entities</td>
</tr>
<tr>
<td>810-10-25-49 through 25-54</td>
<td>5.4.12</td>
<td>Implicit variable interests</td>
</tr>
<tr>
<td>810-10-25-55</td>
<td>5.4.5</td>
<td>Financial guarantees, written puts and similar obligations</td>
</tr>
<tr>
<td>810-10-25-55 through 25-56</td>
<td>5.5</td>
<td>Variable interests in specified assets</td>
</tr>
<tr>
<td>810-10-25-57 through 25-58</td>
<td>6.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>810-10-30</td>
<td>12.4</td>
<td>Primary beneficiary of a VIE that is not a business</td>
</tr>
<tr>
<td>810-10-30-1 through to 30-4</td>
<td>12.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>810-10-30-10 through 30-16</td>
<td>12.2</td>
<td>Primary beneficiary and VIE are under common control</td>
</tr>
<tr>
<td>810-10-30-2</td>
<td>12.3</td>
<td>Primary beneficiary of a VIE that is a business</td>
</tr>
<tr>
<td>810-10-35-4</td>
<td>11.1</td>
<td>Reconsideration of whether an entity is a VIE</td>
</tr>
<tr>
<td>810-10-35-6 through 35-9</td>
<td>E.3</td>
<td>Initial measurement</td>
</tr>
<tr>
<td>810-10-45-25</td>
<td>13.1</td>
<td>Presentation</td>
</tr>
<tr>
<td>810-10-50-2AA through 2AC</td>
<td>13.2.1</td>
<td>Disclosure objectives</td>
</tr>
<tr>
<td>810-10-50-2AD through 2AF</td>
<td>D.7</td>
<td>Disclosure</td>
</tr>
<tr>
<td>810-10-50-3</td>
<td>13.2.2</td>
<td>Primary beneficiaries of VIEs</td>
</tr>
<tr>
<td>810-10-50-4</td>
<td>13.2.3</td>
<td>Holders of variable interests in VIEs that are not primary beneficiaries</td>
</tr>
<tr>
<td>810-10-50-5A</td>
<td>13.2.2</td>
<td>Primary beneficiaries of VIEs</td>
</tr>
<tr>
<td>810-10-50-5A</td>
<td>13.2.3</td>
<td>Holders of variable interests in VIEs that are not primary beneficiaries</td>
</tr>
<tr>
<td>810-10-50-5A through 5B</td>
<td>13.2.4</td>
<td>All holders of variable interests in VIEs</td>
</tr>
<tr>
<td>810-10-50-6</td>
<td>13.2.5</td>
<td>Scope-related disclosures</td>
</tr>
<tr>
<td>810-10-50-9</td>
<td>13.2.6</td>
<td>Aggregation of certain disclosures</td>
</tr>
<tr>
<td>810-10-50-10</td>
<td>13.2.6</td>
<td>Aggregation of certain disclosures</td>
</tr>
<tr>
<td>810-10-50-20 through 50-22</td>
<td>E.5</td>
<td>Disclosure</td>
</tr>
<tr>
<td>810-10-55-1</td>
<td>C.3.2.1.1</td>
<td>Evaluating the substance of noncontrolling rights</td>
</tr>
<tr>
<td>810-10-55-1B</td>
<td>12.4.1</td>
<td>Contingent consideration in an asset acquisition when the entity is a VIE that does not constitute a business</td>
</tr>
<tr>
<td>810-10-55-8A through 8H</td>
<td>4.2.7</td>
<td>Series funds</td>
</tr>
<tr>
<td>810-10-55-17 through 55-19</td>
<td>5.2.2.1</td>
<td>Consideration 1: Which variable interests absorb the variability designated in Step 1?</td>
</tr>
<tr>
<td>810-10-55-20</td>
<td>5.4</td>
<td>Illustrative examples of variable interests</td>
</tr>
<tr>
<td>810-10-55-21</td>
<td>5.2.2.2</td>
<td>Consideration 2: Is the variable interest in a specified asset of a VIE, a silo or a VIE as a whole?</td>
</tr>
<tr>
<td>810-10-55-22</td>
<td>5.4.1</td>
<td>Equity investments</td>
</tr>
<tr>
<td>810-10-55-22</td>
<td>5.4.3</td>
<td>Trust preferred securities</td>
</tr>
<tr>
<td>810-10-55-23 through 55-24</td>
<td>5.4.2</td>
<td>Beneficial interests and debt instruments</td>
</tr>
<tr>
<td>810-10-55-25 through 55-26</td>
<td>5.4.5</td>
<td>Financial guarantees, written puts and similar obligations</td>
</tr>
<tr>
<td>810-10-55-25</td>
<td>5.4.12</td>
<td>Implicit variable interests</td>
</tr>
<tr>
<td>810-10-55-27 through 27-28</td>
<td>5.4.4.2</td>
<td>Forward contracts</td>
</tr>
<tr>
<td>ASC paragraph</td>
<td>Section</td>
<td>Description</td>
</tr>
<tr>
<td>---------------------</td>
<td>---------</td>
<td>-------------------------------------------------------</td>
</tr>
<tr>
<td>810-10-55-29</td>
<td>5.4.4.1</td>
<td>Common derivative contracts</td>
</tr>
<tr>
<td>810-10-55-30</td>
<td>5.4.4.3</td>
<td>Total return swaps</td>
</tr>
<tr>
<td>810-10-55-31</td>
<td>5.4.4.4</td>
<td>Embedded derivatives</td>
</tr>
<tr>
<td>810-10-55-37</td>
<td>5.4.9.2</td>
<td>Joint service agreements</td>
</tr>
<tr>
<td>810-10-55-37 through 55-38</td>
<td>5.4.13</td>
<td>Fees paid to decision makers or service providers</td>
</tr>
<tr>
<td>810-10-55-37 through 55-38</td>
<td>7.3.1.4</td>
<td>Effect of decision makers or service providers when evaluating ASC 810-10-15-14(b)(1)(i)</td>
</tr>
<tr>
<td>810-10-55-37 through 55-38</td>
<td>7.3.1.5</td>
<td>Franchise arrangements when evaluating ASC 810-10-15-14(b)(1)</td>
</tr>
<tr>
<td>810-10-55-37 through 55-38</td>
<td>8.3</td>
<td>Benefits</td>
</tr>
<tr>
<td>810-10-55-37</td>
<td>5.4.13.2</td>
<td>Condition (c): Other interests held by a decision maker or service provider in a VIE</td>
</tr>
<tr>
<td>810-10-55-37</td>
<td>5.4.13.3</td>
<td>Fees that expose a reporting entity to risk of loss</td>
</tr>
<tr>
<td>810-10-55-37</td>
<td>5.4.13.4</td>
<td>Reconsideration of a decision maker’s or service provider’s fees as variable interests</td>
</tr>
<tr>
<td>810-10-55-37B</td>
<td>A.8</td>
<td>Example analysis of sufficiency of equity</td>
</tr>
<tr>
<td>810-10-55-37</td>
<td>5.4.13.1</td>
<td>Conditions (a) and (d): Fees are commensurate with the level of effort required and include only customary terms and conditions</td>
</tr>
<tr>
<td>810-10-55-37D</td>
<td>2.7</td>
<td>Indirect interest</td>
</tr>
<tr>
<td>810-10-55-37D</td>
<td>5.4.13.2</td>
<td>Condition (c): Other interests held by a decision maker or service provider in a VIE</td>
</tr>
<tr>
<td>810-10-55-37D</td>
<td>5.4.13.2.1</td>
<td>Interests held by related parties when evaluating fees paid to a decision maker or service provider</td>
</tr>
<tr>
<td>810-10-55-37D</td>
<td>5.4.13.2.2</td>
<td>Interests held by employees when evaluating fees paid to a decision maker or service provider</td>
</tr>
<tr>
<td>810-10-55-39</td>
<td>5.4.7</td>
<td>Operating leases</td>
</tr>
<tr>
<td>810-10-55-4V</td>
<td>C.2.2</td>
<td>Voting Model: Control of limited partnerships and similar entities</td>
</tr>
<tr>
<td>810-10-55-55</td>
<td>5.2.1</td>
<td>Step 1: Determine the variability an entity was designed to create and distribute</td>
</tr>
<tr>
<td>810-10-55-75 through 55-77</td>
<td>5.2.2.1</td>
<td>Consideration 1: Which variable interests absorb the variability designated in Step 1?</td>
</tr>
<tr>
<td>810-10-55-81 through 55-86</td>
<td>5.2.2.1</td>
<td>Consideration 1: Which variable interests absorb the variability designated in Step 1?</td>
</tr>
<tr>
<td>810-10-55-81 through 55-86</td>
<td>5.4.4.2</td>
<td>Forward contracts</td>
</tr>
<tr>
<td>810-10-55-86</td>
<td>5.2.1</td>
<td>Step 1: Determine the variability an entity was designed to create and distribute</td>
</tr>
<tr>
<td>810-10-55-87 through 55-89</td>
<td>D.8</td>
<td>Elimination of implicit variable interest guidance applicable to all entities</td>
</tr>
<tr>
<td>810-10-55-93 through 55-205</td>
<td>8.2.3</td>
<td>Steps 3 and 4: Identify how decisions about significant activities are made and the party or parties that make them</td>
</tr>
<tr>
<td>810-10-55-205AS through 205AT</td>
<td>E.3</td>
<td>Initial measurement</td>
</tr>
<tr>
<td>ASC paragraph</td>
<td>Section</td>
<td>Description</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>---------</td>
<td>-------------------------------------------------------</td>
</tr>
<tr>
<td>810-10-55-205C through 205I</td>
<td>D.6</td>
<td>Illustrations</td>
</tr>
<tr>
<td>810-10-65-4</td>
<td>D.9</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>810-10-65-6</td>
<td>E.6</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>810-10-65-7</td>
<td>14.1</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>810-10-65-7</td>
<td>14.2</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>810-10-65-7</td>
<td>14.2.4</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>810-10-65-7(g)</td>
<td>14.2.2.1</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>810-30</td>
<td>1.1.2</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>810-30</td>
<td>C.1.2</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>810-30</td>
<td>C.1.2</td>
<td>Scope of the voting interest entity model</td>
</tr>
<tr>
<td>815-15-25-1</td>
<td>5.4.4.4</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>820-10-55-4 through 55-20</td>
<td>A.6</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>825-10</td>
<td>14.2.2.2</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>830-20-30-2</td>
<td>C.3.1</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>840-10-15</td>
<td>D.3</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>840-40</td>
<td>D.1</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>850-10-20</td>
<td>10</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>850-10-20</td>
<td>10.1</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>944-80-25-3</td>
<td>10.2.3</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>946-10-15-4 through 15-9</td>
<td>F.1.1</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>946-210-45-7</td>
<td>F.2.1.1</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>946-810-45-2 through 45-3</td>
<td>F.2</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>946-810-45-3</td>
<td>C.1.2</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>952-10-20</td>
<td>4.4.4.2.2</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>958-810</td>
<td>4.4.1</td>
<td>Effective date and transition</td>
</tr>
<tr>
<td>958-810</td>
<td>C.1.2</td>
<td>Effective date and transition</td>
</tr>
</tbody>
</table>
Summary of important changes

The following sections were updated as a result of the issuance of ASU 2015-02:

Chapter 1: Overview
- All Sections

Chapter 2: Definition of terms
- Section 2.1, Legal entity
- Section 2.3, Common control
- Section 2.4, Decision maker and decision-making authority
- Section 2.5, Power
- Section 2.7, Indirect interest
- Section 2.8, Kick-out rights and liquidation rights
- Section 2.9, Participating rights
- Section 2.10, Protective rights
- Section 2.20, Reporting entity and entity

Chapter 4: Scope
- Section 4.2.7, Series funds (Updated in February 2016)
- Section 4.3.2, Investment companies
- Section 4.3.4, Money market funds

Chapter 5: Evaluation of variability and identifying variable interests
- Section 5.4.1.1, Interests held by employees
- Section 5.4.13, Fees paid to decision makers or service providers
- Section 5.4.13.1, Conditions (a) and (d): Fees are commensurate with the level of effort required and include only customary terms and conditions (Updated in February 2016)
- Section 5.4.13.2, Condition (c): Other interests held by a decision maker or service provider (Updated in February 2016)
- Section 5.4.13.2.1, Interests held by related parties when evaluating fees paid to a decision maker or service provider (Updated in February 2016)
- Section 5.4.13.2.2, Interests held by employees when evaluating fees paid to a decision maker or service provider
- Section 5.4.13.3, Fees that expose a reporting entity to risk of loss
Chapter 7: Determining whether an entity is a VIE
- Section 7.3.1, The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance

Chapter 8: Primary beneficiary determination
- Section 8.2.3.1, Related party considerations
- Section 8.2.4.1, Kick-out rights
- Section 8.2.4.2, Participating rights
- Section 8.2.4.3, Protective rights
- Section 8.3.1, Fees paid to decision makers or service providers

Chapter 9: Determining the primary beneficiary in a related party group
- Section 9.1, Introduction
- Section 9.2, Single decision maker (Updated in February 2016)
- Section 9.3, Shared power among multiple related parties
- Section 9.4, Multiple decision makers or service providers within the related party group

Chapter 14: Effective date and transition
- All Sections

Appendix B: Affordable housing projects
- All Sections

Appendix C: Voting Model and consolidation of entities controlled by contract
- Sections C1, C2
- Section C3 (Updated in February 2016)

Appendix G: Lot option contracts
- New appendix

The following sections were updated as follows:
- Section 4.4.4.1, Business scope exception, was updated to discuss the FASB's proposal to change the definition of a business.
- Section 7.2.4, Development stage entities, was updated for the issuance of ASU 2014-10.
- Appendix C.3.1, Foreign currency exchange restrictions, was updated for speech made by Christopher D. Semesky at the 2015 AICPA National Conference on Current SEC and PCAOB Developments available at www.sec.gov.
- Appendix D.9, Effective date and transition, was updated to discuss the FASB's proposal to eliminate the effective date in the consolidation PCC alternative.
- Appendix F, Investment companies, was added as a result of ASU 2015-02 and the issuance of US Securities and Exchange Commission, Division of Investment Management, Investment Management Guidance Update No. 2014-11
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2016 Ernst & Young LLP.
All Rights Reserved.
SCORE no. BB3099
(Revised February 2016)

This and many of the publications produced by our US Professional Practice Group, are available free on AccountingLink at www.ey.com/us/accountinglink.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.