

Financial reporting developments

A comprehensive guide

Consolidation

Determination of a controlling financial interest and accounting for changes in ownership interests

June 2023

To our clients and other friends

This Financial reporting developments publication is designed to help you understand the financial reporting issues associated with applying the consolidation models and consolidation procedure. It includes excerpts from and references to the Accounting Standards Codification (ASC or Codification) of the Financial Accounting Standards Board (FASB or Board) interpretive guidance and examples.

The guidance on applying the Variable Interest Model or the Voting Model is complex, and knowing when and how to apply each model can be challenging. Consolidation evaluations always begin with the Variable Interest Model, which applies to all entities, with certain limited exceptions. The Variable Interest Model focuses on identifying the reporting entity with power to make the decisions that most significantly impact the economic performance of an entity being evaluated for consolidation. That power may be exercisable through equity interests or other means. It also requires determining whether a reporting entity with power has benefits, which means the obligation to absorb losses or the right to receive benefits from an entity that potentially could be significant to the entity.

We updated this Financial reporting developments (FRD) publication to reflect standard-setting developments and to provide enhancements to our interpretive guidance. See Appendix C for a summary of updates.

We hope this publication will help you understand and apply the consolidation guidance in ASC 810. We are also available to answer your questions and discuss any concerns you may have.

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style script.

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Contents

1	Overview	1
1.1	The models	1
1.1.1	Variable Interest Model	1
1.1.2	Voting Model (updated June 2023)	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?	5
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?	14
1.3	Summary	19
2	Definitions of terms	20
2.1	Legal entity	20
2.2	Controlling financial interest	20
2.3	Common control	21
2.3.1	Assessing common control with respect to the private company accounting alternative	23
2.4	Decision maker and decision-making authority	23
2.5	Power	23
2.6	Expected losses, expected residual returns and expected variability	24
2.7	Indirect interest	25
2.8	Kick-out rights and liquidation rights	25
2.9	Participating rights	26
2.10	Protective rights	27
2.11	Primary beneficiary	28
2.12	Related parties and de facto agents	28
2.13	Subordinated financial support	29
2.14	Variable interest entity	30
2.15	Variable interests	30
2.16	Collateralized financing entity	31
2.17	Voting interest entity	31
2.18	Private company	31
2.19	Public business entity	32
2.20	Reporting entity and entity	32
2.21	Ordinary course of business	33
3	Consideration of substantive terms, transactions and arrangements	34
4	Scope	36
4.1	Introduction	36
4.2	Legal entities	37
4.2.1	Common arrangements/entities subject to the Variable Interest Model	37
4.2.2	Portions of entities	39

4.2.3	Collaborative arrangements not conducted through a separate entity.....	40
4.2.4	Majority-owned entities	40
4.2.5	Application of Variable Interest Model to tiered structures.....	41
4.2.6	Fiduciary accounts, assets held in trust	42
4.2.7	Series funds.....	42
4.3	Scope exceptions to consolidation guidance	46
4.3.1	Employee benefit plans	47
4.3.1.1	Employee benefit plans not subject to ASC 712 or ASC 715	47
4.3.1.2	Employee stock ownership plans.....	47
4.3.1.3	Deferred compensation trusts (e.g., a rabbi trust)	48
4.3.1.4	Applicability of the Variable Interest Model to the financial statements of employee benefit plans.....	49
4.3.1.5	Service providers to employee benefit plans	49
4.3.2	Investment companies	49
4.3.3	Governmental entities	49
4.3.3.1	Governmental financing entities	49
4.3.4	Money market funds	50
4.4	Scope exceptions to the Variable Interest Model.....	52
4.4.1	Not-for-profit organizations (updated August 2022).....	53
4.4.1.1	Not-for-profit organizations used to circumvent consolidation	54
4.4.1.2	Not-for-profit organizations as related parties.....	55
4.4.2	Separate accounts of life insurance reporting entities	55
4.4.3	Information availability.....	55
4.4.4	Business scope exception	56
4.4.4.1	Significant participation in the design or redesign of an entity.....	57
4.4.4.1.1	Determining whether an entity is a joint venture.....	58
4.4.4.1.2	Determining whether an entity is a franchisee	59
4.4.4.2	Substantially all of the activities of an entity either involve or are conducted on behalf of a reporting entity.....	60
4.4.4.3	A reporting entity and its related parties have provided more than half of an entity's subordinated financial support.....	61
4.4.4.4	The activities of the entity are primarily related to securitizations or single-lessee leasing arrangements.....	61
4.4.5	Private company accounting alternative.....	62
5	Evaluation of variability and identifying variable interests	63
5.1	Introduction	63
5.2	Step-by-step approach to identifying variable interests	64
5.2.1	Step 1: Determine the variability an entity was designed to create and distribute	65
5.2.1.1	Consideration 1: What is the purpose for which the entity was created?.....	66
5.2.1.2	Consideration 2: What is the nature of the risks in the entity?	66
5.2.1.2.1	Certain interest rate risk.....	67
5.2.1.2.2	Terms of interests issued.....	69
5.2.1.2.3	Subordination	69
5.2.2	Step 2: Identify variable interests.....	70
5.2.2.1	Consideration 1: Which variable interests absorb the variability designated in Step 1?.....	71

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?.....	73
5.3	Quantitative approach to identifying variable interests.....	73
5.4	Illustrative examples of variable interests.....	74
5.4.1	Equity investments.....	74
5.4.1.1	Interests held by employees	75
5.4.2	Beneficial interests and debt instruments	75
5.4.3	Trust preferred securities	76
5.4.4	Derivative instruments	79
5.4.4.1	Common derivative contracts.....	81
5.4.4.2	Forward contracts.....	83
5.4.4.3	Total return swaps	84
5.4.4.4	Embedded derivatives	85
5.4.5	Financial guarantees, written puts and similar obligations	88
5.4.6	Purchase contracts	90
5.4.7	Leases.....	90
5.4.7.1	Operating leases – reporting entity is the lessee	91
5.4.7.2	Capital leases and finance leases – reporting entity is the lessee	92
5.4.7.3	Leases – reporting entity is the lessor	92
5.4.8	Lease prepayments.....	93
5.4.9	Local marketing agreements and joint service agreements in the broadcasting industry... 93	
5.4.9.1	Local marketing agreements	93
5.4.9.2	Joint service agreements	94
5.4.10	Purchase contracts for real estate	94
5.4.11	Netting or offsetting contracts.....	95
5.4.12	Implicit variable interests.....	97
5.4.13	Fees paid to decision makers or service providers	101
5.4.13.1	Conditions (a) and (d): Fees are commensurate with the level of effort required and include only customary terms and conditions.....	104
5.4.13.2	Condition (c): Other interests held by a decision maker or service provider.....	106
5.4.13.2.1	Interests held by related parties when evaluating fees paid to a decision maker or service provider (updated June 2023).....	109
5.4.13.2.2	Interests held by employees when evaluating fees paid to a decision maker or service provider	113
5.4.13.3	Fees that expose a reporting entity to risk of loss	113
5.4.13.4	Reconsideration of a decision maker’s or service provider’s fees as variable interests	116
5.5	Variable interests in specified assets.....	117
6	Silos.....	121
6.1	Introduction	121
6.2	Determining whether the host entity is a VIE when silos exist	124
6.3	Effect of silos on determining variable interests in specified assets	127
6.3.1	Relationship between specified assets and silos	128

7	Determining whether an entity is a VIE.....	130
7.1	Introduction	130
7.2	The entity does not have enough equity to finance its activities without additional subordinated financial support	130
7.2.1	Forms of investments that qualify as equity investments.....	132
7.2.2	Determining whether an equity investment is at risk	134
7.2.2.1	Equity investment participates significantly in both profits and losses	134
7.2.2.2	Equity interests that were issued by the entity in exchange for subordinated interests in other VIEs	136
7.2.2.3	Amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity	136
7.2.2.4	Amounts financed for the equity holder directly by the entity or by other parties involved with the entity	140
7.2.2.5	Other examples of determining equity investments at risk	142
7.2.3	Methods for determining whether an equity investment at risk is sufficient	145
7.2.3.1	10% test – a misnomer	146
7.2.3.2	The entity can finance its activities without additional subordinated financial support	146
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	147
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.....	148
7.2.3.5	Illustrative examples	150
7.2.4	Development stage entities	152
7.3	The equity holders, as a group, lack the characteristics of a controlling financial interest	152
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	153
7.3.1.1	Step 1: Consider purpose and design	155
7.3.1.2	Step 2: Identify the activities that most significantly impact the entity's economic performance (updated June 2023).....	155
7.3.1.2.1	Industry examples of significant activities (added June 2023).....	156
7.3.1.3	Step 3: Determine how decisions about significant activities are made and the party or parties that make them	157
7.3.1.3.1	Corporations and similar entities.....	157
7.3.1.3.2	Limited partnerships and similar entities	161
7.3.1.3.3	Kick-out rights.....	164
7.3.1.3.4	Participating rights.....	167
7.3.1.3.5	Protective rights	169
7.3.1.4	Effect of decision makers or service providers when evaluating ASC 810-10-15-14(b)(1).....	171
7.3.1.5	Franchise arrangements when evaluating ASC 810-10-15-14(b)(1).....	172
7.3.1.6	Limited liability companies (updated August 2022)	173
7.3.2	Obligation to absorb an entity's expected losses	175
7.3.2.1	Common arrangements that may protect equity investments at risk from absorbing losses.....	178
7.3.2.2	Disproportionate sharing of losses	180

7.3.2.3	Variable interests in specified assets or silos	181
7.3.2.4	Illustrative examples	182
7.3.3	Right to receive an entity's expected residual returns.....	183
7.3.3.1	Disproportionate sharing of profits	185
7.3.3.2	Variable interests in specified assets or silos	186
7.3.3.3	Illustrative examples	187
7.4	Entity established with non-substantive voting rights	188
7.4.1	Condition 1: Votes are disproportionate to economics	189
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	190
7.4.3	Related party and de facto agent considerations.....	193
7.4.4	Illustrative examples	195
7.5	Initial determination of VIE status	196
8	Primary beneficiary determination.....	198
8.1	Introduction	198
8.2	Power	200
8.2.1	Step 1: Consider purpose and design.....	200
8.2.1.1	Involvement with the design of the VIE	200
8.2.2	Step 2: Identify the activities that most significantly impact the VIE's economic performance.....	201
8.2.3	Steps 3 and 4: Determine how decisions about significant activities are made and the party or parties that make them.....	203
8.2.3.1	Related party considerations	207
8.2.3.2	Situations in which no party has the power over a VIE	207
8.2.3.3	Shared power	208
8.2.3.4	Power conveyed through a board of directors and no one party controls the board.....	210
8.2.3.5	Multiple unrelated parties direct the same activities that most significantly impact the VIE's economic performance	210
8.2.3.6	Multiple unrelated parties direct different activities that most significantly impact the VIE's economic performance	211
8.2.3.6.1	Different parties with power over the entity's life cycle	212
8.2.3.6.2	Evaluating rights held by the board of directors and an operations manager in an entity.....	213
8.2.4	Kick-out rights, participating rights and protective rights.....	216
8.2.4.1	Kick-out rights	216
8.2.4.2	Participating rights.....	217
8.2.4.3	Protective rights	218
8.2.4.4	Potential voting rights (e.g., call options, convertible instruments).....	219
8.3	Benefits.....	219
8.3.1	Fees paid to decision makers or service providers	223
8.3.2	Evaluating disproportionate power and benefits	225
8.4	Other frequently asked questions	227
9	Determining the primary beneficiary in a related party group	228
9.1	Introduction (updated June 2023).....	228
9.2	Single decision maker (updated June 2023).....	231
9.2.1	Single decision maker without a variable interest (added June 2023)	235

9.3	Shared power among multiple related parties.....	236
9.4	Multiple decision makers within the related party group	238
9.5	Determining which party is most closely associated with a VIE	240
9.5.1	Principal-agency relationship	241
9.5.2	Relationship and significance of a VIE's activities to members of a related party group ...	241
9.5.3	Exposure to variability associated with the anticipated economic performance of the VIE	243
9.5.4	Purpose and design.....	243
9.6	One member of a related party group not clearly identified	243
10	Related parties and de facto agents	244
10.1	Introduction	244
10.2	Related parties	245
10.3	De facto agents	245
10.3.1	A party that received its interests as a contribution or a loan from the reporting entity...246	
10.3.2	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	247
10.3.2.1	One-sided versus two-sided restrictions	248
10.3.2.2	Common contractual terms	248
10.3.2.2.1	Right of first refusal.....	248
10.3.2.2.2	Right of first offer.....	248
10.3.2.2.3	Approval cannot be unreasonably withheld	249
10.3.2.2.4	Restrictions on selling interests to competitors.....	249
10.3.3	A party that has a close business relationship	249
10.3.4	Separate accounts of insurance entities as potential related parties.....	249
11	Voting Model and consolidation of entities controlled by contract	251
11.1	Introduction	251
11.1.1	SEC regulations on consolidation	252
11.1.2	Scope of the Voting Model	253
11.2	Voting Model: Controlling financial interests.....	254
11.2.1	Voting Model: Consolidation of corporations.....	255
11.2.1.1	Consolidation of a not-for-profit organization	255
11.2.2	Voting Model: Control of limited partnerships and similar entities	257
11.2.2.1	Not-for-profits that are the general partner of a for-profit limited partnership	259
11.2.3	Circumstances when more than a simple majority is required for control.....	260
11.2.4	Evaluating indirect control	260
11.2.5	Evaluating call options, convertible instruments and other potential voting rights.....	262
11.2.6	Control when owning less than a majority of voting shares	262
11.2.6.1	Evaluating size of minority investment relative to other minority investors.....	263
11.3	Exceptions to consolidation by a reporting entity holding a majority of voting stock or limited partnership interests.....	264
11.3.1	Foreign currency exchange restrictions.....	265
11.3.2	Evaluating the effect of noncontrolling rights.....	265
11.3.2.1	Participating rights.....	267
11.3.2.1.1	Evaluating the substance of noncontrolling rights	270
11.3.2.2	Protective rights	274
11.3.3	Timing of assessment of control for a voting interest entity	275
11.4	Control by contract	276

12 Reconsideration events	277
12.1 Reconsideration of whether an entity is a VIE	277
12.1.1 Common VIE reconsideration events.....	278
12.1.1.1 Conversions of accounts receivables into notes.....	280
12.1.1.2 Transfer of an entity's debt between lenders.....	280
12.1.1.3 Asset acquisitions and dispositions	280
12.1.1.4 Distributions to equity holders	281
12.1.1.5 Replacement of temporary financing with permanent financing.....	282
12.1.1.6 Adoption of accounting standards	282
12.1.1.7 Incurrence of losses that reduce the equity investment at risk	283
12.1.1.8 Acquisition of a business that has a variable interest in an entity.....	283
12.1.1.9 Bankruptcy	283
12.1.1.10 Change in power due to an event (e.g., loan default)	283
12.1.1.11 Contract modifications due to LIBOR transition (updated June 2023)	284
12.2 Continuous assessment of whether a reporting entity is the primary beneficiary	286
12.2.1 Changes to the primary beneficiary when a contract is modified as a result of reference rate reform (updated June 2023).....	287
13 Initial measurement and consolidation of a VIE	288
13.1 Introduction	288
13.2 Primary beneficiary and VIE are under common control.....	288
13.3 Primary beneficiary of a VIE that is a business.....	288
13.4 Primary beneficiary of a VIE that is not a business	289
13.4.1 Contingent consideration in an asset acquisition when the entity is a VIE that does not constitute a business	290
13.4.2 Subsequent accounting for in-process research and development (IPR&D) and contingent consideration.....	290
13.5 Primary beneficiary of a VIE that is a collateralized financing entity	291
13.5.1 Measurement alternative for consolidated collateralized financing entities	291
13.6 SEC reporting considerations (updated June 2023).....	295
13.7 Pre-existing hedge relationships under ASC 815	296
13.8 Continuation of leveraged lease accounting by an equity investor in a deconsolidated lessor trust.....	296
14 Consolidated financial statements	298
14.1 Introduction	298
14.1.1 Acquisition through a single investment	298
14.1.2 Acquisition through multiple investments	298
14.1.2.1 Income tax considerations related to gaining control of a subsidiary	299
14.2 Undivided interests and proportionate consolidation.....	299
14.3 Differing fiscal year-ends between parent and subsidiary	302
14.4 Using subsidiary financial statements prepared as of an earlier period end for consolidation procedures in circumstances when the subsidiary has the same fiscal year end as the parent.....	303
14.4.1 Reporting lag in the period of obtaining control.....	304
14.4.2 Reporting lag in the period of losing control.....	304
14.5 Subsidiary's accounting basis is not US GAAP.....	305
14.6 Differing accounting policies between parent and subsidiary (updated August 2022).....	305

15 Nature and classification of a noncontrolling interest	307
15.1 Noncontrolling interests (updated August 2022)	307
15.1.1 Noncontrolling interests in consolidated variable interest entities	310
15.1.2 Initial recognition and measurement of a noncontrolling interest	310
15.2 Equity contracts issued on the stock of a subsidiary (e.g., redeemable noncontrolling interests)	311
16 Attribution of net income or loss and comprehensive income or loss	312
16.1 Attribution procedure	312
16.1.1 Substantive profit-sharing arrangements	312
16.1.2 Attribution of losses in excess of noncontrolling interest's carrying amount	317
16.1.2.1 Distribution in excess of the noncontrolling interest's carrying amount	318
16.1.3 Attribution to noncontrolling interests held by preferred shareholders	318
16.1.4 Attribution of goodwill impairment	320
16.1.5 Attribution related to business combinations	321
16.1.5.1 Attribution related to business combinations before the adoption of FAS 141(R) ..	321
16.1.6 Effect of attribution on a parent's effective income tax rate	322
16.1.7 Attribution of dividends payable in nonmonetary assets	323
16.1.8 Attribution to redeemable NCI	323
16.1.8.1 Attribution of dividends of a consolidated trust issuing trust preferred securities ..	324
17 Intercompany eliminations	325
17.1 Procedures for eliminating intercompany balances and transactions	325
17.1.1 Effect of NCI on intercompany eliminations – overview	326
17.1.2 Effect of NCI on intercompany eliminations for VIEs	327
17.1.2.1 Accounting for liabilities of a VIE after initial consolidation	329
17.1.3 Shares of a parent held by its subsidiary (reciprocal interest)	330
17.1.3.1 Presentation in the subsidiary's separate financial statements	330
17.1.4 Intercompany derivative transactions	331
17.1.5 Deferred taxes on dividends of foreign operations	331
17.1.6 Effect of intercompany inventory transfers on LIFO liquidation	331
17.2 Examples	332
18 Changes in a parent's ownership interest in a subsidiary while control is retained	347
18.1 Introduction (updated August 2022)	347
18.2 Retaining a controlling financial interest (updated August 2022)	348
18.3 Scope of guidance in ASC 810 on a change in interest (without loss of control) (updated August 2022)	349
18.3.1 Increases in a parent's ownership interest in a subsidiary (updated August 2022)	351
18.3.2 Scope of ASC 810 for decreases in a parent's ownership interest in a subsidiary without loss of control (updated August 2022)	351
18.3.2.1 Decrease in interest in a subsidiary that is a business (updated August 2022)	351
18.3.2.1.1 Scope exception for oil and gas conveyances	351
18.3.2.1.2 Scope exception for revenue contracts with customers	352
18.3.2.2 Decreases in ownership interest of a subsidiary that is not a business or a nonprofit activity	352
18.3.2.2.1 Decrease in interest – substance addressed by ASC 606 (added August 2022)	353
18.3.2.2.2 Decrease in interest – substance addressed by ASC 845	353

18.3.2.2.3	Decrease in interest – substance addressed by ASC 860.....	353
18.3.2.2.4	Decrease in interest – substance addressed by ASC 932 (added August 2022)	355
18.3.2.2.5	Decrease in interest – substance addressed by ASC 610-20 (updated August 2022)	355
18.3.2.2.6	Decrease in interest – substance not addressed by other GAAP	355
18.3.3	Subsidiaries acquired before adoption of FAS 160 and FAS 141R.....	356
18.4	Accounting for changes in a parent’s ownership interest in a subsidiary in a transaction within the scope of ASC 810.....	357
18.4.1	Contingent consideration in an increase in interest	358
18.4.2	Accumulated other comprehensive income considerations in a change in interest	359
18.4.2.1	Accounting for foreign currency translation adjustments.....	360
18.4.3	Allocating goodwill upon a change in a parent’s ownership interest.....	361
18.4.4	Accounting for transaction costs incurred upon a change in a parent’s ownership interest	361
18.4.5	Income tax considerations	362
18.5	Other decrease in ownership transactions without a loss of control (added August 2022).....	362
18.5.1	Issuance of a stock option by a subsidiary.....	362
18.5.2	Issuance or redemption of preferred stock by a subsidiary.....	362
18.5.3	Issuance by a subsidiary of partnership units that have varying profit or liquidation preferences.....	363
18.5.3.1	Issuance of preferential limited partnership units by a Master Limited Partnership account	364
18.5.4	Issuance of subsidiary shares as consideration in a business combination.....	365
18.5.5	Noncontrolling interests in a common control transaction	365
18.6	Examples of changes in a parent’s ownership interest when the parent maintains control of a subsidiary in a transaction in the scope of ASC 810	365
18.6.1	Consolidation at the acquisition date	366
18.6.2	Consolidation in year of combination.....	367
18.6.3	Consolidation after parent purchases an additional interest.....	369
18.6.4	Consolidation after parent sells a portion of its interest	370
18.6.5	Consolidation after subsidiary issues additional shares.....	371
18.6.6	Consolidation after subsidiary acquires outstanding shares from noncontrolling interest holder.....	373
19	Loss of control over a subsidiary or a group of assets	375
19.1	Introduction (added August 2022).....	375
19.2	Losing a controlling financial interest.....	375
19.2.1	Deconsolidation through multiple arrangements.....	376
19.2.2	Deconsolidation through a bankruptcy proceeding or governmentally imposed restrictions.....	377
19.3	Scope of guidance in ASC 810 on loss of control.....	377
19.3.1	Loss of control of a business.....	381
19.3.1.1	Scope exception for oil and gas conveyances	381
19.3.1.2	Scope exception for revenue contracts with customers (added August 2022)	382
19.3.2	Loss of control of a subsidiary that is a not a business.....	382
19.3.2.1	Loss of control – substance addressed by ASC 606 (updated August 2022).....	382
19.3.2.2	Loss of control – substance addressed by ASC 845 (updated August 2022).....	383

19.3.2.3	Loss of control – substance addressed by ASC 860	383
19.3.2.4	Loss of control – substance addressed by ASC 932 (added August 2022)	385
19.3.2.5	Loss of control – substance addressed by ASC 610-20 (added August 2022).....	385
19.3.2.6	Loss of control of a subsidiary that is not a business – substance not addressed by other GAAP.....	390
19.3.3	Loss of control through a transfer under common control	391
19.4	Calculate the gain or loss upon losing control	391
19.4.1	Identify other elements of the transaction	393
19.4.2	Measure the fair value of consideration received.....	393
19.4.2.1	Accounting for contingent consideration upon a loss of control (updated June 2023)	394
19.4.3	Measure the fair value of any retained noncontrolling investment.....	397
19.4.3.1	Measuring a retained creditor interest	398
19.4.3.2	Subsequent accounting for a retained noncontrolling investment	398
19.4.4	Determine the carrying amount of the noncontrolling interest	398
19.4.5	Determine the carrying amount of the former subsidiary’s assets and liabilities.....	399
19.4.5.1	Assignment of goodwill upon a loss of control	399
19.4.5.2	Accounting for accumulated other comprehensive income upon a loss of control	399
19.4.5.2.1	Foreign currency translation adjustments	399
19.4.6	Income tax considerations related to the loss of control over a subsidiary	400
19.4.7	Classification and presentation of a gain or loss upon loss of control	400
19.5	Examples.....	401
19.5.1	Deconsolidation by selling entire interest.....	402
19.5.2	Deconsolidation by selling a partial interest	404
19.5.3	Deconsolidation as a result of dilution	406
20	Combined financial statements	407
20.1	Purpose of combined financial statements	407
20.1.1	Common operations and management	408
20.2	Preparing combined financial statements.....	408
21	Parent-company financial statements	410
21.1	Purpose of parent-company financial statements	410
21.1.1	Investments in subsidiaries	411
21.1.2	Investments in non-controlled entities	411
21.1.3	Disclosure requirements.....	411
22	Consolidating financial statements.....	412
22.1	Purpose of consolidating financial statements	412
22.2	Form and content of consolidating financial statements	413
22.2.1	Intercompany and other adjustments	413
22.2.2	Investments in subsidiaries	414
22.2.3	Cash flow information	416
22.3	Disclosures for consolidating financial statements	417
22.4	Example consolidating financial statements.....	417
23	Presentation and disclosures	423
23.1	Presentation of VIEs	423
23.2	Disclosures for VIEs	425

23.2.1	Disclosure objectives	425
23.2.2	Primary beneficiaries of VIEs	426
23.2.3	Holders of variable interests in VIEs that are not primary beneficiaries.....	427
23.2.4	All holders of variable interests in VIEs	428
23.2.5	Scope-related VIE disclosures	429
23.2.6	Aggregation of certain VIE disclosures	429
23.2.7	Public company VIE disclosure requirements	431
23.2.8	Private company accounting alternative.....	431
23.2.9	Measurement alternative for consolidated collateralized financing entities	431
23.2.10	Wholly foreign-owned enterprises, including China-based issuers (added August 2022)	432
23.3	Other procedures and disclosure requirements related to consolidation.....	434
23.3.1	Consolidated statements of net income and comprehensive income presentation	435
23.3.2	Reconciliation of equity presentation	435
23.3.2.1	Presentation of redeemable noncontrolling interests in the equity reconciliation ...	436
23.3.2.2	Interim reporting period requirements	436
23.3.3	Consolidated statement of financial position presentation	437
23.3.4	Consolidated statement of cash flows presentation.....	438
23.3.4.1	Presentation of transaction costs in the statement of cash flows.....	438
23.3.5	Disclosures for deconsolidation of a subsidiary in the scope of ASC 810.....	438
23.3.6	Disclosures required upon a change in the entities consolidated	440
23.4	Example of presentation and disclosures under ASC 810	441
A	Abbreviations used in this publication	A-1
B	Index of ASC references in this publication	B-1
C	Summary of important changes	C-1
D	Expected losses and expected residual returns	D-1
D.1	Introduction	D-1
D.2	Expected losses, expected residual returns and expected variability	D-1
D.3	Calculating expected losses and expected residual returns	D-3
D.3.1	Effect of variable interests in specified assets or silos.....	D-5
D.4	Allocation of expected losses and expected residual returns.....	D-5
D.5	Reasonableness checks.....	D-10
D.6	Approaches to calculate expected losses and expected returns	D-11
D.6.1	Fair value, cash flow and cash flow prime methods	D-12
D.6.1.1	Fair value method	D-12
D.6.1.2	Cash flow method	D-13
D.6.1.3	Cash flow prime method.....	D-13
D.7	Inability to obtain the information	D-17
D.8	Example analysis of sufficiency of equity.....	D-17
E	Private company accounting alternative for common control arrangements (updated June 2023)	E-1
E.1	Overview (updated June 2023)	E-1
E.2	Scope (updated June 2023).....	E-1
E.3	Evaluating common control (updated June 2023)	E-3
E.4	Illustrations (updated June 2023).....	E-4
E.5	Disclosures (updated June 2023)	E-9

F	Affordable housing projects	F-1
F.1	Summary of the tax credit (updated June 2023)	F-1
F.2	Summary of the investment	F-2
F.3	Primary beneficiary considerations (updated June 2023)	F-3
G	Investment companies	G-1
G.1	Overview	G-1
G.1.1	Attributes of an investment company	G-1
G.2	Consolidation by an investment company	G-2
G.2.1	Master/feeder and fund of funds structures.....	G-5
G.2.1.1	SEC staff views on consolidation in master/feeder and fund of funds structures ...	G-7
G.3	Consolidation of investment companies	G-8
G.4	Combined financial statements under the Custody Rule	G-9
H	Lot option contracts	H-1
H.1	Introduction	H-1
H.2	Background	H-1
H.3	Determining whether a homebuilder has a variable interest in the entity	H-2
H.3.1	Variable interests in specified assets	H-2
H.3.2	Other considerations	H-2
H.4	Determining whether the entity is a VIE.....	H-3
H.4.1	The entity does not have sufficient equity to finance its activities without additional subordinated financial support	H-3
H.4.2	The equity holders, as a group, lack the characteristics of a controlling financial interest	H-4
H.4.2.1	The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance	H-4
H.4.2.2	Obligation to absorb an entity's expected losses	H-4
H.4.2.3	Right to receive the entity's expected residual returns.....	H-5
H.4.3	Entity established with non-substantive voting rights	H-5
H.5	Determining whether the homebuilder is the primary beneficiary	H-5
H.5.1	Power.....	H-6
H.5.2	Benefits.....	H-6
H.6	Reconsideration events	H-6
H.7	Recognition and measurement	H-7
H.8	Disclosures	H-7

Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (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 in turn 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.

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1 Overview

ASC 810 defines a subsidiary as an entity in which a parent has a controlling financial interest, either through voting interests or other means (such as variable interests). When a reporting entity has a controlling financial interest in an entity, it accounts for the assets, liabilities and any noncontrolling interests of that entity in its consolidated financial statements in accordance with the consolidation principles in ASC 810-10-45. These principles are the same for entities consolidated under the Voting Model and Variable Interest Model.

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 sections 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 (LLCs) and trusts.¹ Even a majority-owned entity may be a VIE that is subject to consolidation in accordance with the Variable Interest Model.

Misconception: Operating entity

The Variable Interest Model does not apply to the entity I am evaluating because the entity is an operating entity.

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.

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. While portions of entities generally are not considered separate entities, the Variable Interest Model includes the concept of a silo, which is a discrete portion of a VIE that may be consolidated separately from the host VIE (see section 6 for additional guidance on identifying silos).

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 (updated June 2023)

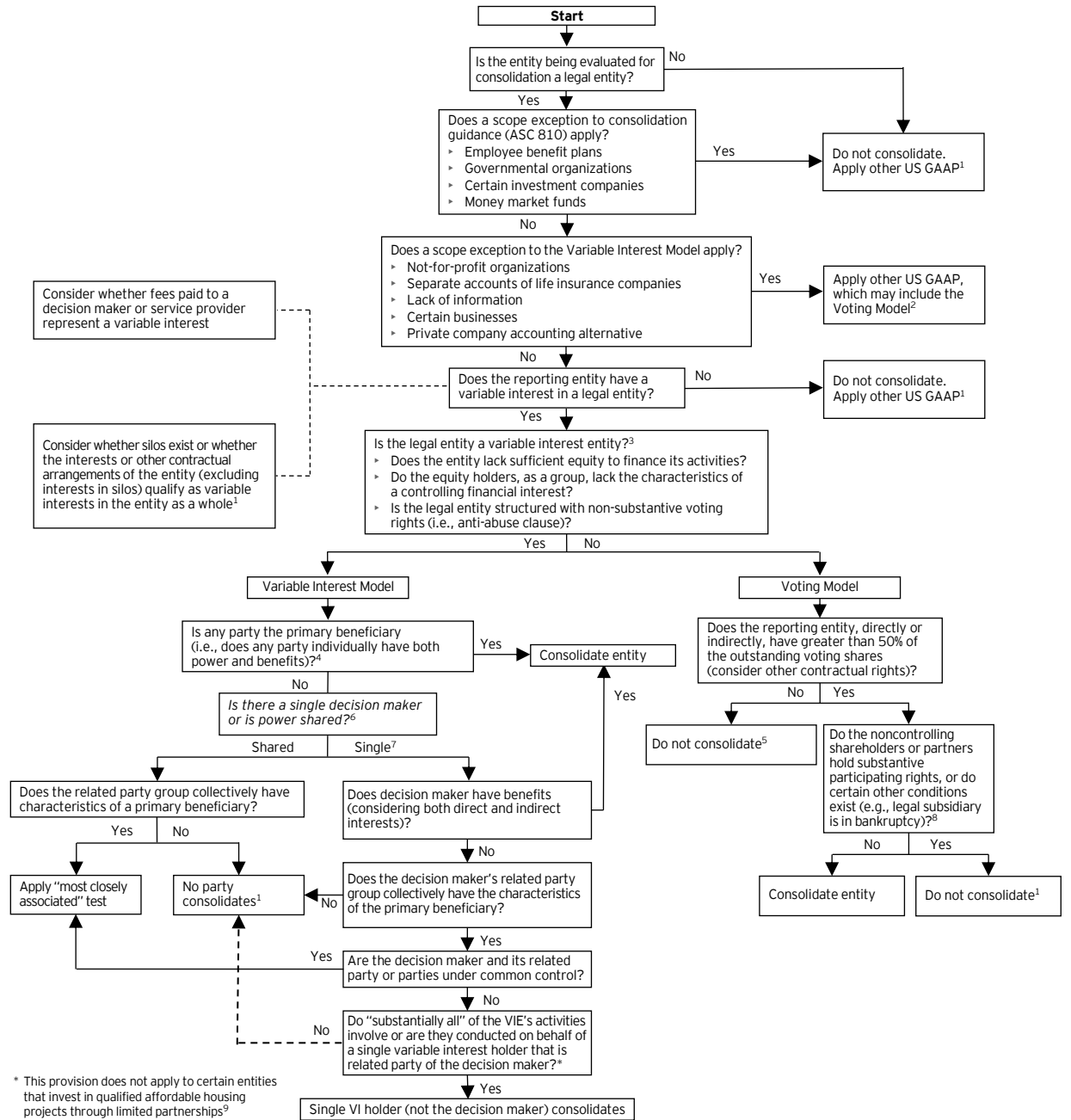
The Voting Model generally can be subdivided into two categories: (1) consolidation of corporations and (2) consolidation of limited partnerships and similar entities. Consolidation of corporations is based upon whether a reporting entity owns more than 50% of the outstanding voting shares of an entity. 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 generally would not consolidate a limited partnership that is a voting interest entity.

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 section 11 for further guidance on the Voting Model and entities controlled by contract. See section 4.3 for guidance on the scope exceptions to consolidation guidance.

The following chart illustrates how to generally apply consolidation accounting guidance.



Consider whether fees paid to a decision maker or service provider represent a variable interest

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 whole⁵

^{*} This provision does not apply to certain entities that invest in qualified affordable housing projects through limited partnerships⁹

¹ Consolidation is not required; however, evaluation of other US GAAP may be relevant to determine recognition, measurement or disclosure.

² 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.

³ ASC 810-10-15-14 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 subordinated 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.
 - For all legal entities other than limited partnerships and similar legal entities, 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).
 - For all limited partnerships and similar legal entities, partners lack that power through voting rights or similar rights if both (1) a single limited partner, a simple majority, or a lower threshold of partners' voting interests with equity at risk are unable to exercise substantive kick-out rights (including liquidation rights) over the general partner(s) and (2) limited partners with equity at risk are not able to exercise substantive participating rights over the general partner(s).
 - ii. The obligation to absorb expected losses
 - iii. The right to receive expected residual returns
- c. The equity investors' voting rights are not proportional to the economics and substantially all of the activities of the entity either involve or are conducted on behalf of an investor that has disproportionately few voting rights.

- ⁴ 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:
- 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.
- ⁵ 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.
- ⁶ 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 power to direct the activities that most significantly impact the entity's economic performance. That is, one party has the power (see section 8.2.3.6).
- ⁷ When multiple parties direct different activities that most significantly impact the VIE's economic performance, one of the parties will be identified as a single decision maker, as discussed in section 8.2.3.6.
- ⁸ For limited partnerships and similar entities, kick-out rights are analogous to voting rights held by shareholders of a corporation. See section 11.2.2 for assessing control of limited partnerships and similar entities under the Voting Model.
- ⁹ The primary beneficiary provisions of the Variable Interest Model specifically exempt limited partners in tax credit program structures that meet the conditions for applying the proportional amortization method from having to assess whether they benefit from "substantially all" of the entity's activities (ASC 810-10-25-44B). As noted in paragraph BC72 of ASU 2015-02, the FASB was concerned that these investors would be required to consolidate the partnerships, despite not meeting the power test, which would have undermined the objective of ASU 2014-01. The exemption has been limited to investors in low-income housing tax structures, but ASU 2023-02 broadened the scope of the proportional amortization guidance in ASC 323-740 to include equity investments in all tax credit programs that meet certain conditions. Therefore, the adoption of ASU 2023-02 could result in investors in other tax credit structures being exempt from the "substantially all" assessment. For public business entities, ASU 2023-02 is effective for annual and interim periods beginning after 15 December 2023. For all entities other than public business entities, ASU 2023-02 is effective for annual and interim periods beginning after 15 December 2024. Early adoption is permitted for annual and interim periods.

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:

- Does a scope exception to consolidation guidance (ASC 810) apply?
- Does a scope exception to the Variable Interest Model apply?
- If a scope exception does not apply, does the reporting entity have a variable interest in an entity?
- If the reporting entity has a variable interest in an entity, is the entity a VIE?
- 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 ASC 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 investees that are not investment companies (unless a noninvestment company investee is providing services to the investment company as discussed in ASC 946-810-45-3) under ASC 810. That is, an investment company generally accounts for its investments in non-investment companies at fair value in accordance with the specialized accounting guidance in ASC 946. See Appendix G for additional guidance when the investment company is the reporting entity.
- ▶ 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).

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. See Appendix G for additional guidance on consolidating an investment company or when the investment company is the reporting entity.

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

As discussed in section 4.4, there are five other scope exceptions specific to the Variable Interest Model:

- ▶ 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.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 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 common control arrangements under the Variable Interest Model if certain criteria are met. See Appendix E for further information.

Business scope exception

As discussed in section 4.4.4, 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 applies the voting interest entity guidance in 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. See section 2.1 of our FRD, **Business combinations**, for guidance on the definition of a business.

² However, if a reporting entity is using an 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.

Misconception: Business scope exception

An entity qualifies for the business scope exception because the entity being evaluated for consolidation is a business.

Some 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. Others recognize that all four conditions must be evaluated but spend too much time evaluating each of the conditions. The criteria for the business scope exception were intended to limit the circumstances in which the exception would apply. See section 4.4.4 of this publication for further guidance on the business scope exception.

Misconception: Joint ventures

An entity qualifies for the business scope exception, even though the reporting entity participated in the design of the entity, because the entity is a joint venture.

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. The actual term has a narrow definition for accounting purposes 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) such 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). See section 4 of our FRD, ***Equity method investments and joint ventures***, for further guidance.

Also, keep in mind that if an entity meets the definition of a joint venture, it is still subject to the remaining three criteria of the business scope exception. See section 4.4.4 of this publication for further guidance on the business scope exception.

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. If a reporting entity does not have a variable interest in an entity, the entity is not subject to consolidation under ASC 810 and the reporting entity should account for its interest in accordance with other US GAAP.

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. The Variable Interest Model refers to negative variability as expected losses and positive variability as expected residual returns. Expected losses and expected residual returns are not US GAAP economic losses or profits. See Appendix D for more guidance on these terms.

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 investments or other interests that will absorb portions of a VIE's expected losses or receive portions of the VIE's expected residual returns. Variable interests are 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.

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. The Variable Interest Model also provides guidance on how to consider implicit variable interests. These items require further evaluation and are discussed in detail in section 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 section 5.4.13 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.

Variable interests in specified assets

A reporting entity might hold a variable interest in only a specified asset or group of assets of an entity. If a reporting entity has a variable interest in specified assets of an entity, but not in the entity as a whole, it would not consolidate the entity. If a reporting entity has a variable interest in the entity as a whole, it evaluates whether it is the primary beneficiary of the entity. 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). See section 5.5 for more guidance on identifying variable interests in specified assets.

A reporting entity with a variable interest in specified assets of an entity also should carefully consider whether those specified assets represent a distinct entity (known as a silo) that is separate from the larger host entity. See section 6 for further guidance.

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.

Misconception: Variable interest

If a reporting entity has a variable interest in an entity, the entity is a VIE.

A common misconception is that having a variable interest in an entity means the entity is a VIE. 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, each of which is described in more detail below:

- ▶ 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).

If the entity is not a VIE, the reporting entity evaluates whether it consolidates the entity under the Voting Model.

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 section 7.2).

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 D of this publication.)



FASB update

In November 2019, the FASB proposed amendments that, among other changes, would remove the reference to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, from the definition of “expected losses and expected residual returns” in ASC 810-10-20. The FASB does not intend³ for the changes to have a significant effect on current practice.

³ Paragraph 4 of Proposed ASU, *Codification Improvements*.

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). However, the 10% presumption applies in one direction only (i.e., an equity investment of less than 10% is presumed to be insufficient).⁴

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?"

The reporting entity then determines how decisions about the significant activities are made and identifies the party or parties that make those decisions. The Variable Interest Model does not require each individual equity holder to have power to make the key decisions. Instead, the at-risk 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.

When evaluating whether a corporation or similar entity is a VIE, the analysis focuses on 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

⁴ Paragraph E23 of FIN 46(R).

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.

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.⁵ 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.

⁵ See ASC 810-10-15-8A.

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. Therefore, a reporting entity should carefully evaluate the facts and circumstances of each arrangement.

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.⁶

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 section 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.

⁶ See paragraph A63 of FAS 167.

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 section 7.4.2 of this publication.)

Reconsideration events

A reporting entity reevaluates whether an entity is a VIE upon the occurrence of certain significant events and not at each reporting date. An event is significant if it 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. See section 12 for additional guidance.

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

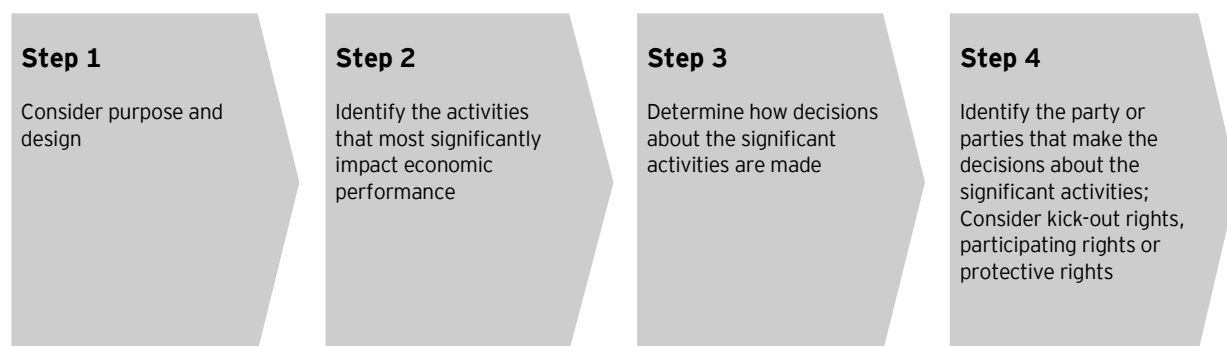
If a reporting entity has concluded it has a variable interest, it likely will meet the benefits criterion. If a reporting entity has a variable interest in a VIE, we believe there is a presumption that the reporting entity has satisfied the benefits criterion. We believe that it would be uncommon for 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.

To determine whether an entity satisfies the benefits criterion, a fee arrangement is excluded if it meets 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.⁷ 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.

⁷ See ASC 810-10-25-38A.

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 section 9 of this publication for further details.

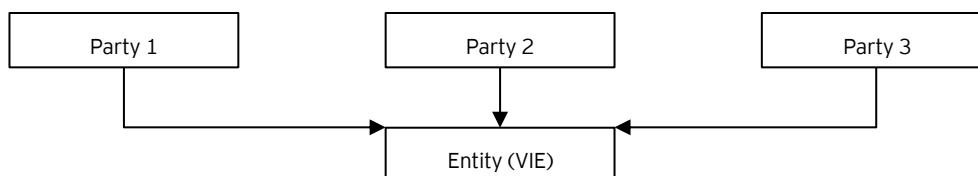
For purposes of the Variable Interest Model, the term "related parties" includes parties identified in ASC 850 and certain other parties that are acting as de facto agents of the variable interest holder unless otherwise specified. For additional guidance on related parties and de facto agents, see section 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.

Multiple unrelated parties direct the activities that most significantly impact the VIE's economic performance

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 section 8.2.3.5 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 section 8.2.3.6 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.

Illustration 1-7: Kick-out rights, participating rights and protective rights		
Rights	Definition	Considerations
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 without cause or to liquidate (dissolve) the entity.	<ul style="list-style-type: none"> ▶ 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).	<ul style="list-style-type: none"> ▶ 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 but may preclude another party from having power ▶ Must be substantive
Protective rights	<p>The ability to block fundamental changes in the activities of an entity or exercise rights that apply only in exceptional circumstances. They could be approval or veto rights. They do not affect the activities that most significantly impact the entity's economic performance.</p> <p>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.</p>	<ul style="list-style-type: none"> ▶ Not considered in assessing whether a reporting entity is the primary beneficiary ▶ Do not provide the holder of such rights with power and do not preclude another party from having power ▶ Designed to protect the interests of the party

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. If more than one unrelated party has to come together to exercise a kick-out right or participating right, the right is not factored into the analysis. Similarly, if a right is not substantive (e.g., because of barriers to exercise), that right is not factored into the analysis. In those circumstances, a single reporting entity (including its related parties and de facto agents) that has the unilateral ability to exercise such rights often will be the party with the power. See section 8.2.4.1 for additional guidance.

Illustration 1-8: Unilateral kick-out right
<p>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.</p> <p>Analysis</p> <p>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.</p>

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.

Continuous assessment

A reporting entity is required 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 occurs when circumstances warrant a change in a reporting entity's status as the primary beneficiary.

1.3

Summary

When applying the Variable Interest Model, remember to ask the questions discussed in this section. 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

Excerpt from Accounting Standards Codification

Consolidation – Overall

Glossary

810-10-20

Legal Entity

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

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

Excerpt from Accounting Standards Codification

Consolidation – Overall

Objectives – General

810-10-10-1

The purpose of **consolidated financial statements** is to present, primarily for the benefit of the **owners** and creditors of the **parent**, the results of operations and the financial position of a parent and all its **subsidiaries** as if the **consolidated group** were a single economic entity. There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities.

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.

810-10-15-8A

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 section 11 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 (EITF) in EITF Issue No. 02-5 (EITF 02-5), *Definition of "Common Control" in Relation to FASB Statement No. 141*, 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.⁸ 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.

⁸ Comments by Donna L. Coallier, SEC Professional Accounting Fellow, at the 1997 AICPA National Conference on SEC Developments.

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.2 of our FRD, ***Business combinations***.

2.3.1 Assessing common control with respect to the private company accounting alternative

A private company is not required to evaluate common control arrangements under the Variable Interest Model if certain criteria are met under a private company accounting alternative. The definition of “common control” used to assess the applicability of the private company accounting alternative differs from the description above in some respects. See section E.3 in Appendix E for more guidance.

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
- ▶ Determine 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 7.3.1 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.

Expected Losses and Expected Residual Returns

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

Expected Residual Returns

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

Expected Variability

Expected variability is the sum of the absolute values of the expected residual return and the expected loss. Expected variability in the fair value of net assets includes expected variability resulting from the operating results of the legal entity.

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 D of this publication.



FASB update

In November 2019, the FASB proposed amendments that, among other changes, would remove the reference to FASB Concepts Statement No. 7 from the definition of “expected losses and expected residual returns” in ASC 810-10-20. The FASB does not intend⁹ for the changes to have a significant effect on current practice.

2.7 Indirect interest

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. Indirect interests also are considered in the identification of the primary beneficiary.

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. For example, if reporting entity A has a 20% interest in entity B, which has a 10% interest in entity C, reporting entity A has an indirect interest in entity C.

See section 5.4.13.2.1 and section 9.2, respectively, for guidance on determining whether fees are a variable interest and on identifying the primary beneficiary.

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.

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.

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.

⁹ Paragraph 4 of Proposed ASU, *Codification Improvements*.

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 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 BC49 of the Background Information and Basis for Conclusions (BC) of ASU 2015-02, liquidation rights are 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. Careful consideration should also be given to determine whether withdrawal (or redemption) rights are considered the same as kick-out rights under the Variable Interest Model (see Question 7.11).

See sections 7.3.1.3 and 8.2.4.1 for a detailed discussion of kick-out rights and their effect on the determination of a VIE and primary beneficiary, respectively.

Under the Voting Model, kick-out rights for limited partnerships and similar entities are analogous to voting rights held by shareholders of a corporation and are used to determine whether any of the limited partners controls a voting interest entity. See section 11.2.2 for assessing control of limited partnerships and similar entities under the Voting Model.

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.

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.

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 sections 7 and 8 for a detailed discussion of participating rights and their effect on the determination of a VIE and primary beneficiary, respectively.

See section 11.3.2.1 for guidance on evaluating participating rights under the Voting Model.

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.

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.

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 section 11.3.2.2 for guidance on evaluating 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 25-38J 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 sections 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.
 1. Subparagraph superseded by Accounting Standards Update No. 2009-17.
 2. Subparagraph superseded by Accounting Standards Update No. 2009-17.
- 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 section 10 for a detailed discussion of related parties and de facto agents, including a table that lists how related parties affect different aspects of the evaluation under the Variable Interest Model.

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 at risk 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 section 4.4 for scope exceptions to the Variable Interest Model and section 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 section 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.

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 at risk 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 section 11 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 elect an accounting policy to be exempt from applying the Variable Interest Model to common control 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 Appendix E for further information.

2.19 Public business entity

Excerpt from Accounting Standards Codification

Consolidation – Overall

Glossary

810-10-20

Public Business Entity

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 notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

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. For example, private companies can choose to be exempt from applying the Variable Interest Model in common control arrangements that meet certain criteria. See Appendix E for further information.

Management should carefully review the definition of a PBE because it includes several types of entities that would not be considered public under other definitions in US GAAP. For example, an entity is considered a PBE if its financial statements (or financial information) are included in another company's SEC filing (e.g., an acquired business, significant equity method investee).

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."

2.21 Ordinary course of business

Excerpt from Accounting Standards Codification

Consolidation – Overall

Glossary

810-10-20

Ordinary Course of Business

Decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out 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 does not include self-dealing transactions.

The term “ordinary course of business” is used when assessing whether rights held by a noncontrolling shareholder to participate in or veto decisions overcome the presumption of consolidation by the majority owner under the Voting Model. The “ordinary course of business” is not limited to events that will occur in the near term, but it must be at least reasonably possible that those events will occur. Determining whether something is expected to occur “in the ordinary course of business” will require judgment, based on the facts and circumstances and the purpose and design of the entity being evaluated. See section 11.3.2 for additional discussion on this topic.

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. A legal entity's status as a **variable interest entity** (VIE)
- b. A reporting entity's power over a VIE
- c. 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.¹⁰ 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.

¹⁰ See paragraph A5 of FAS 167.

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 section 12). 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.

4 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), 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 section 11 for further guidance on the Voting Model and entities controlled by contract.

If, after considering the guidance in ASC 810-10, including the Variable Interest Model, a reporting entity determines that it is not required to consolidate a research and development (R&D) arrangement in which the sponsor of the arrangement provides all of the funds for the R&D program, it should apply ASC 810-30 to these arrangements.¹¹ Accordingly, we believe it will be relatively rare that entities apply ASC 810-30. See section R7.2.7, ***Consolidation considerations for R&D arrangements in which all funds are provided by a sponsor***, of our Accounting Manual for more guidance.

¹¹ ASC 810-30-15-3(b)

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 Model. Portions of entities, such as divisions, departments and branches, are not considered separate entities under the Variable Interest Model 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 section 6).

Determining whether a structure meets the definition of a legal entity requires the consideration of the individual facts and circumstances and may require the assistance of legal counsel. When this evaluation proves challenging, answering “yes” to some or all of the following questions may suggest the structure is a legal entity.

Can the structure, under its own name (i.e., apart from other parties):

- ▶ Enter into contracts?
- ▶ Enter into or become part of court or regulatory proceedings?
- ▶ File a tax return?
- ▶ Open a bank account or obtain financing?

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
- ▶ Entities used to facilitate leasing arrangements:
 - ▶ Build-to-suit arrangements
 - ▶ Leases including lessee guarantees of asset values
 - ▶ Leases including lessee purchase options
 - ▶ Sale-leasebacks (or sale and leaseback after the adoption of ASC 842)
 - ▶ 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 (see Appendix F)
 - ▶ 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).¹²

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 section 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 section 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.

¹² See Question 3-2 in FIN 46(R).

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 section 23 for more guidance on disclosures).

4.2.5 Application of Variable Interest Model to tiered structures

Excerpt from Accounting Standards Codification

Consolidation – Overall

Implementation Guidance and Illustrations – Variable Interest Entities

Variable Interest of One VIE in Another VIE

810-10-55-40

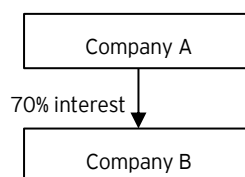
One VIE is the primary beneficiary of another VIE if it meets the conditions in paragraph 810-10-25-38A. A VIE that is the primary beneficiary of a second VIE will consolidate that second VIE. If another reporting entity consolidates the first VIE, that reporting entity's consolidated financial statements include the second VIE because the second VIE had already been consolidated by the first. For example, if Entity A (a VIE) is the primary beneficiary of Entity B (a VIE), Entity A consolidates Entity B. If Entity C is the primary beneficiary of Entity A, Entity C consolidates Entity A, and Entity C's consolidated financial statements include Entity B because Entity A has consolidated Entity B.

We believe the Variable Interest Model generally should apply 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 and whether they are considered related parties). See section 9 for additional guidance and section 10 for identifying related parties and de facto agents.

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 the parent of that VIE. 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



The balance sheets of Company A and Company B are as follows:

Company A (standalone)				Company B			
Investment in Co. B	\$ 35			Securities	\$ 300	Debt	\$ 400
Other assets	132	Equity	\$ 167	Loans	150	Equity	50
	<u>\$ 167</u>		<u>\$ 167</u>		<u>\$ 450</u>		<u>\$ 450</u>

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.

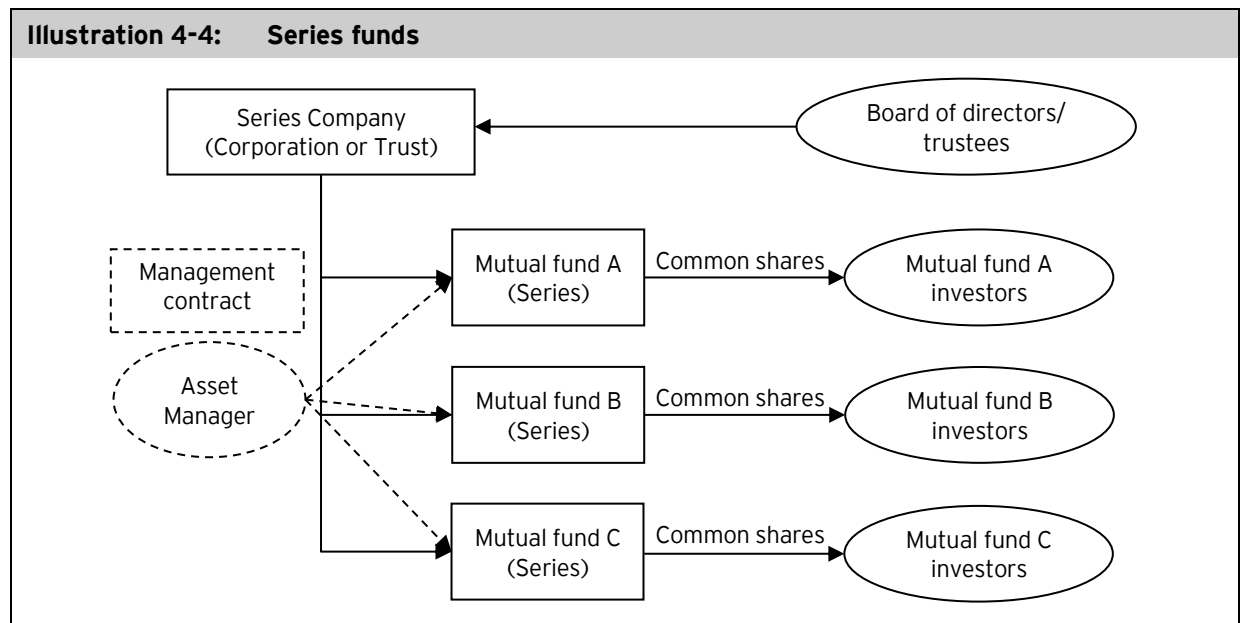
In evaluating whether Company A is a VIE, we believe Company A's standalone balance sheet – without consolidation of Company B – should be used. That is, Company A should be evaluated based on its own contractual arrangements without consideration of Company B's financial position. In this case, Company 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

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.



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

Excerpt from Accounting Standards Codification

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.

810-10-55-8C

The asset management company is compensated on the basis of an established percentage of assets under management in the respective series funds for directing the activities of each fund within its stated objectives. The fees paid to the asset management company are both of the following:

- a. Compensation for services provided and commensurate with the level of effort required to provide the services
- b. Part of service arrangements that include only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

810-10-55-8D

The asset management company has sold 65 percent of the shares in Fund A to external shareholders and holds the remaining 35 percent of shares in Fund A.

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.

810-10-55-8F

For this series fund structure, the voting rights in paragraph 810-10-55-8E(a) are exercised at the (umbrella) trust level. That is, a simple majority vote of shareholders of all of the series funds (Fund A, Fund B, and Fund C) is required to exercise the voting right to remove and replace the Board of Trustees of the (umbrella) trust. However, the voting rights in paragraph 810-10-55-8E(b) through (i) are series fund-level rights. That is, only a simple majority vote of Series Fund A's shareholders is required to exercise the voting rights in paragraph 810-10-55-8E(b) through (i) for Series Fund A.

810-10-55-8G

According to paragraph 810-10-15-14(b)(1), one condition for a legal entity to be considered a VIE is that, as a group, the holders of the equity investment at risk lack 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. Paragraph 810-10-15-14(b)(1)(i) indicates that, 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).

810-10-55-8H

The shareholders in each series fund lack the ability at a series-specific level to remove and replace the Board of Trustees of the (umbrella) trust, because the shareholders in each series fund are required to vote on an aggregate basis to exercise that right. However, based on an evaluation of the purpose and design of each series fund, the shareholders in each series fund are able to direct the activities of the funds that most significantly impact the funds' economic performance through their voting rights. For example, the activities that most significantly impact the economic performance of Fund A, which include making decisions on how to invest the assets of that fund, are carried out by the asset management company. However, the shareholders of Fund A are able to effectively direct those activities through the voting rights in paragraph 810-10-55-8E(b) through (d). Shareholders of Fund A lack the unilateral ability to remove and replace the Board of Trustees. However, because shareholders have the ability to directly remove and replace the asset management company, approve the compensation of the asset management company, and vote on the investment strategy of Fund A, the investors are deemed to have the power through voting rights to direct the activities of Fund A that most significantly impact the fund's economic performance in accordance with paragraph 810-10-15-14(b)(1). Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for Fund A to be considered a VIE, Fund A would be considered a voting interest entity.

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. As discussed in paragraph BC38 of ASU 2015-02, 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 BC39 of 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 BC38 of 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 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 ASC 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 ASC 715

While employee benefit arrangements not subject to ASC 712 or ASC 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 ASC 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 ASC 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 ASC 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 (except as discussed in ASC 946-810-45-3) or the disclosure requirements of ASC 810. See Appendix G 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

A reporting entity is 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 1940 Act. To determine whether a fund operates in accordance with requirements that are "similar" to Rule 2a-7, the reporting entity considers the purpose and design of the fund, including its portfolio quality, maturity and diversification.

As noted in paragraph BC82 of 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.¹³

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.

Question 4.3

If an unregistered money market fund, which is not required to comply with Rule 2a-7 of the 1940 Act, 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 are 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 is not in the best interest of the fund. Boards of these funds 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 are permitted but not required to impose fees and gates.

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 that became 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 not to qualify for the money market fund scope exception.

¹³ Paragraph BC79 of ASU 2015-02.

4.4

Scope exceptions to the Variable Interest Model

Excerpt from Accounting Standards Codification**Consolidation – Overall*****Scope and Scope Exceptions – Variable Interest Entities*****810-10-15-13**

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.

810-10-15-17

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

- a. **Not-for-profit entities** (NFPs) are not subject to the Variable Interest Entities Subsections, except that they may be related parties for purposes of applying paragraphs 810-10-25-42 through 25-44. In addition, if an NFP is used by business reporting entities in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entities Subsections, that NFP shall be subject to the guidance in the Variable Interest Entities Subsections.
- b. Separate accounts of life insurance entities as described in Topic 944 are not subject to consolidation according to the requirements of the Variable Interest Entities Subsections.
- c. A reporting entity with an interest in a VIE or potential VIE created before December 31, 2003, is not required to apply the guidance in the Variable Interest Entities Subsections to that VIE or legal entity if the reporting entity, after making an exhaustive effort, is unable to obtain the information necessary to do any one of the following:
 1. Determine whether the legal entity is a VIE
 2. Determine whether the reporting entity is the VIE's primary beneficiary
 3. Perform the accounting required to consolidate the VIE for which it is determined to be the primary beneficiary.

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

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

3. The reporting entity and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity based on an analysis of the fair values of the interests in the legal entity.
4. The activities of the legal entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.

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

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 (updated August 2022)

Excerpt from Accounting Standards Codification Master Glossary

Glossary

810-10-20

Not-for-Profit Entity

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

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

Entities that clearly fall outside this definition include the following:

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

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 they have a controlling financial interest in an entity. Additionally, as long as a for-profit reporting entity is not using a not-for-profit organization to circumvent the Variable Interest Model, it does **not** evaluate a not-for-profit organization for consolidation under the Variable Interest Model, but it **does** evaluate whether to consolidate the not-for-profit organization under the Voting Model (i.e., the general subsections of ASC 810-10). The guidance under the entities controlled by contract subsections of ASC 810-10 also could apply.

These evaluations are summarized in the following table:

		Entity being evaluated for consolidation	
		Not-for-profit entity	For-profit entity
Reporting entity	Not-for-profit entity	Apply ASC 958-810	
	For-profit entity	Apply other sections of ASC 810 (excluding the Variable Interest Model) (see sections 11.2.1.1 and 11.4)	Apply ASC 810, beginning with the Variable Interest Model (unless another scope exception applies)

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.¹⁴

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 (lessee) 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.

Analysis

Because the charitable foundation is being used by Company A to avoid consolidating the VIE, 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.

¹⁴ See paragraph C8 of FIN 46 and paragraph E8 of FIN 46(R).

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 a variable interest to the not-for-profit organization. See sections 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.¹⁵

See section 10.3.4 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. See Question 23.4 for guidance when an insurer concludes that an investment fund should be consolidated and a portion of the fund is owned by the insurer's separate accounts.

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).¹⁶ 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.

¹⁵ See paragraph E11 of FIN 46(R).

¹⁶ See paragraph D12 of FIN 46(R).

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 a reporting entity uses this scope exception, it is required to provide the disclosures in ASC 810-10-50-6, as discussed in section 23.2.5.

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 initially consolidates the entity through a cumulative catch-up adjustment based on the guidance in ASC 810-10-30-7 through 810-10-30-9.

As discussed in a December 2003 speech,¹⁷ 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 that 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. In determining whether an entity has inappropriately applied this scope exception, the SEC staff will 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, 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.¹⁸ 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.

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. ASC 805 provides guidance for determining what constitutes a business when applying the scope exception. See section 2.1 of our FRD, *Business combinations*, for further discussion of the definition of a business.

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.

¹⁷ Comments by Eric Schuppenhauer, SEC Professional Accounting Fellow, at the 2003 AICPA National Conference on Current SEC and PCAOB Developments. We believe that references to FIN 46(R) in the speech also would apply to the current Variable Interest Model.

¹⁸ Comments by Jane D. Poulin, Associate Chief Accountant, at the 2004 AICPA National Conference on Current SEC and PCAOB Developments. We believe that references to FIN 46(R) in the speech also would apply to the current 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 section 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

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 section 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 section 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 section 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.

4.4.4.1.1

Determining whether an entity is a joint venture**Excerpt from Accounting Standards Codification****Consolidation – Overall****Glossary****323-10-20****Corporate Joint Venture**

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

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.

To meet the definition of a joint venture, an arrangement must have all of the following characteristics:

- ▶ The arrangement must be organized within a separate legal entity.
- ▶ The entity must be under the joint control of the venturers.
- ▶ The venturers must be able to exercise joint control of the entity through their equity investments.
- ▶ The qualitative characteristics of the entity, including its purpose and design, must be consistent with the definition of a joint venture.

Regarding the first characteristic of a 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.

The second characteristic of a joint venture is joint control, 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. 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).

Regarding the third characteristic of a joint venture, if a 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.

The fourth characteristic of a joint venture is that the purpose of the entity must be consistent with that of a joint venture. Therefore, the purpose of the entity should be 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.

Determining whether an entity is a joint venture will depend on the facts and circumstances and will require the use of professional judgment. See section 4 of our FRD, *Equity method investments and joint ventures*, for further guidance. 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.

4.4.4.1.2 *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.

Excerpt from Accounting Standards Codification Master Glossary

Franchisors – Overall

Glossary

952-10-20

Franchise Agreement

A written business agreement that meets the following principal criteria:

- 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.
- 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.
- 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.
- 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.
- 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.)

- 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.

The payment of an initial franchise fee or a continuing royalty fee is not a necessary criterion for an agreement to be considered a franchise agreement.

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).

4.4.4.2

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.)

4.4.4.3 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:

Subordinated financial support	Book basis	Fair value basis		
		Provided by Investco	Provided by others	Total
Debt	\$ 500	\$ 400	\$ 200	\$ 600
Preferred stock	700	500	–	500
Common stock	1,000	100	300	400
	<u>\$ 2,200</u>	<u>\$ 1,000</u>	<u>\$ 500</u>	<u>\$ 1,500</u>

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.

4.4.4.4 The activities of the entity are primarily related to securitizations or single-lessee leasing arrangements

If the activities of the entity are primarily related to securitizations or single-lessee leasing arrangements, the reporting entity cannot apply the business scope exception, regardless of the type of lease (e.g., operating or finance). This determination will depend on the facts and circumstances, including the purpose and design of the entity and the substance of the arrangements. It is important to remember that the criteria for the business scope exception were intended to limit when the exception would apply.

See section 5.4.7 for guidance on determining whether a lease is a variable interest and section 8.2.3 for guidance on identifying the primary beneficiary of a single asset entity that is a VIE. See section 5.4.12 for guidance on implicit variable interests, which are common in such arrangements.

Illustration 4-7: Determining whether the activities of an entity are primarily related to single-lessee leasing arrangements

The purpose and design of Entity A, the potential VIE, is to own and lease commercial buildings to Entity B, the reporting entity. Entity A meets the definition of a business in ASC 805 and leases all of its commercial buildings to Entity B.

Analysis

Although Entity A meets the definition of a business, its primary activity is leasing its commercial buildings to a single lessee, Entity B. Therefore, Entity B cannot apply the business scope exception to Entity A and would evaluate whether it is required to consolidate Entity A under the Variable Interest Model, unless another scope exception applies.

Question 4.4

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

Private companies may elect an accounting policy to be exempt from applying the Variable Interest Model in common control arrangements that meet certain criteria. The FASB's goal was to allow private companies to simplify their accounting for these arrangements, while providing relevant information to users of private company financial statements.¹⁹ See Appendix E for further information, including considerations for each of the criteria, illustrations, disclosures and transition.

¹⁹ Paragraph BC33 of ASU 2014-07 and paragraph BC25 of ASU 2018-17.

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.

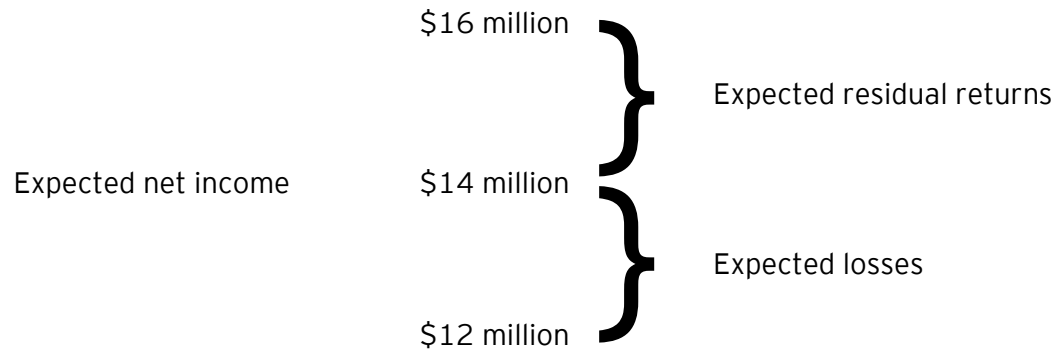
A reporting entity must hold a variable interest(s) in an entity to consolidate that entity. If a reporting entity does not have a variable interest in an entity, the entity is not subject to consolidation under ASC 810 and the reporting entity should account for its interest in accordance with other US GAAP.

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:

**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 D 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 (e.g., credit risk, operations risk, interest rate risk) 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, based on its purpose and design. 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.

Variable interests include equity investments, debt instruments, guarantees, certain leases and implicit interests. The Variable Interest Model provides separate criteria for determining whether fees paid to an entity's decision makers or service providers represent variable interests in an entity (see section 5.4.13) and evaluating variable interests in specified assets (see section 5.5). The labeling of an item as an asset, liability, equity or contractual arrangement does not determine whether that item is a variable interest.

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

Consolidation – Overall

Recognition – Variable Interest Entities

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 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:

Asset		Liabilities	
B-Rated bond – Fixed interest rate	\$ 100	Senior debt – Floating rate	\$ 80
		Equity	\$ 20

The entity enters into a fixed to floating (Secured Overnight Financing Rate (SOFR)) 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 SOFR 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

Asset		Liabilities	
B-Rated Bond – Floating rate	\$ 100	Senior debt – Fixed rate	\$ 80
		Equity	\$ 20

The entity enters into a floating (SOFR) 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 D 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.
- ▶ 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.

810-10-55-32

Assets held by a VIE almost always create variability and, thus, are not variable interests. However, as discussed separately in this Subsection, assets of the VIE that take the form of derivatives, guarantees, or other similar contracts may be variable interests.

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. What distinguishes 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 create risk in an entity generally are not variable interests in the entity. Assets held by a VIE almost always create variability and, thus, generally are not variable interests.

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 through 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 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 section 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 D 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 sections 7.2 and 8.3, 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.

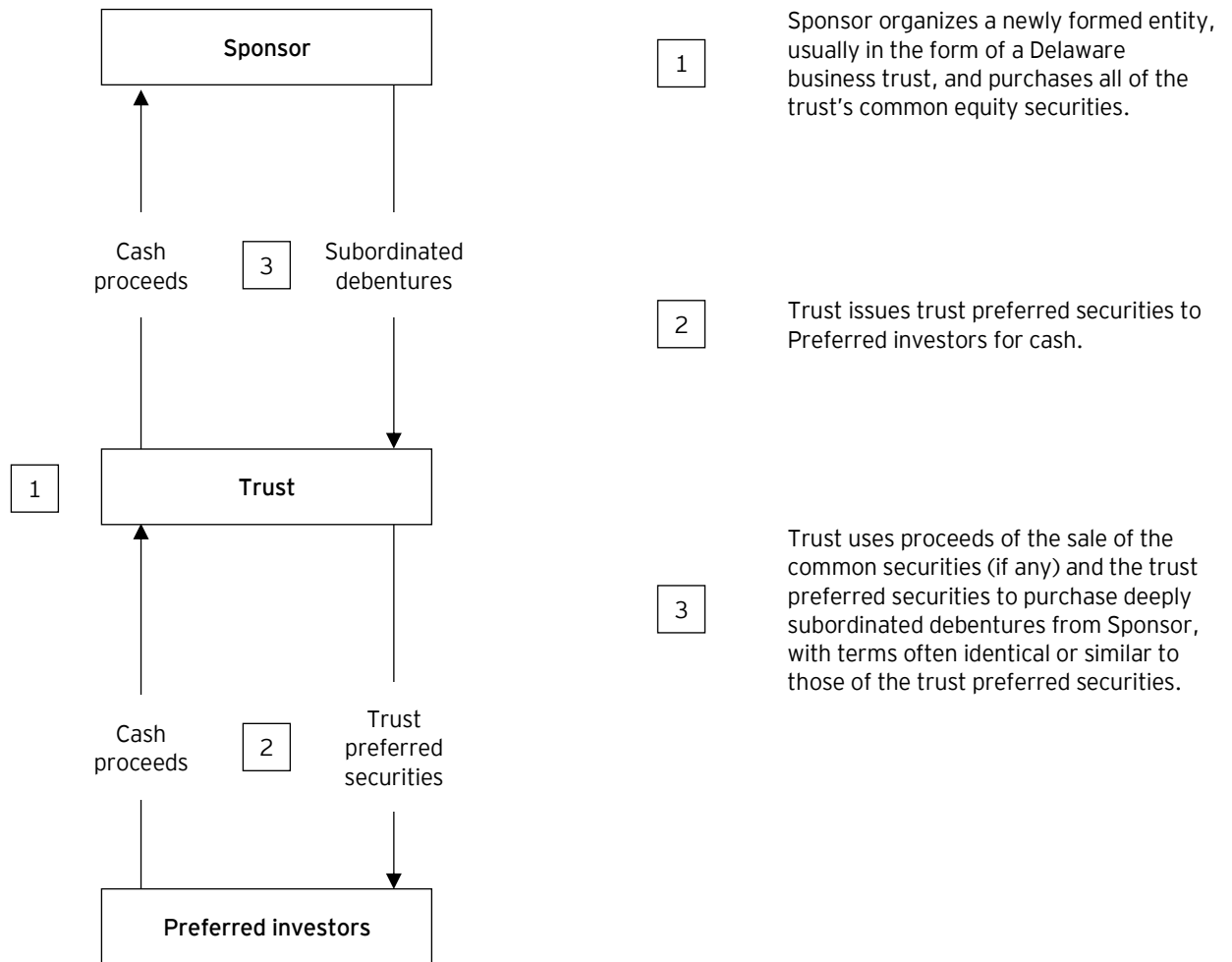
The following summarizes a typical trust preferred securities arrangement.

- ▶ 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).

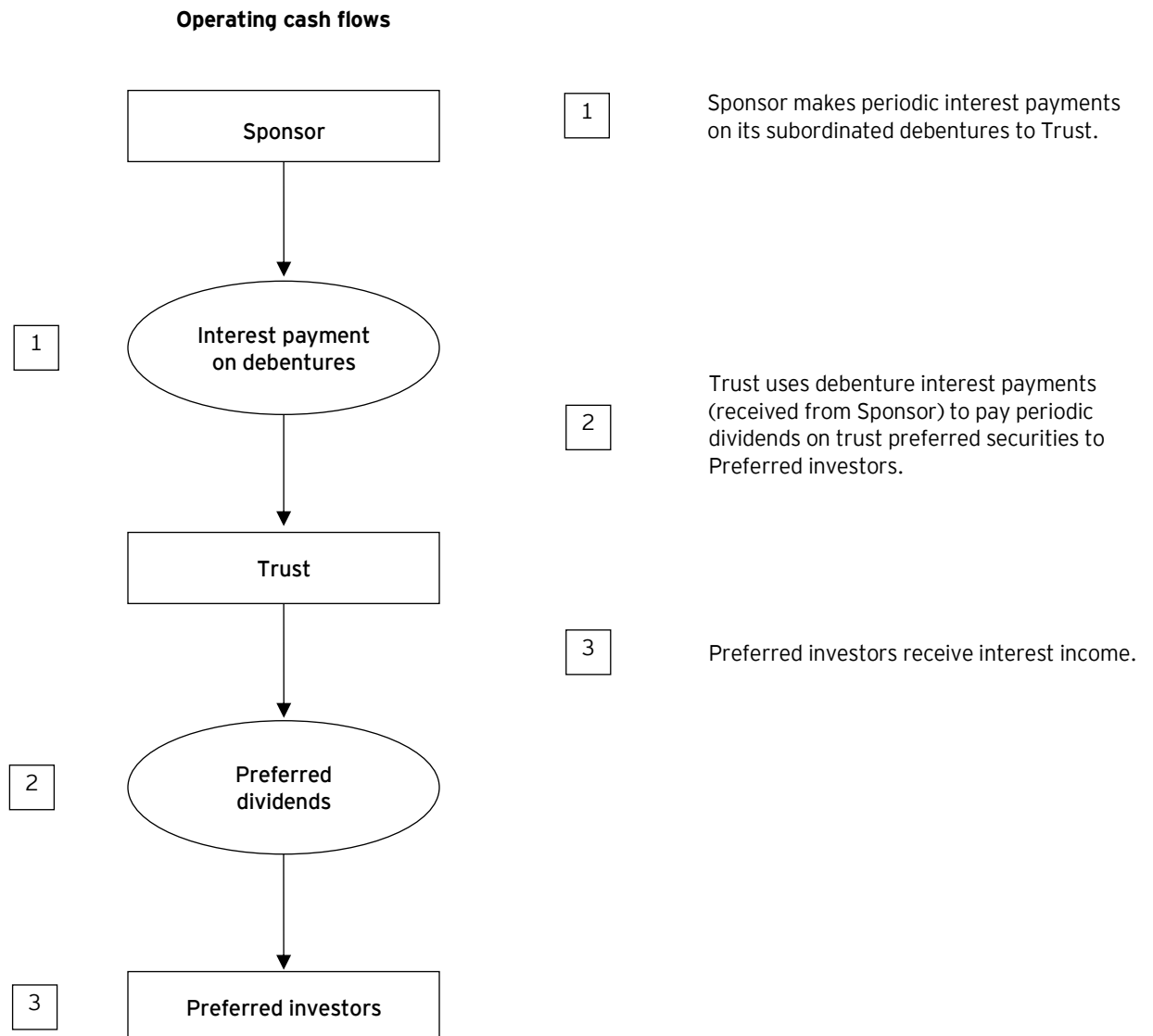
Typically, in these arrangements, the trust's preferred investors have the rights of preferred shareholders and do not have creditor rights unless the sponsor directly issues an incremental credit guarantee to the investors. Additionally, the trust's preferred investors generally do not have voting rights 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



This diagram summarizes the operating cash flows between Sponsor, Trust and Investors.



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.

Other guidance

See section 5.6 of our FRD, *Issuer's accounting for debt and equity financings*, for more information on the accounting for trust preferred securities.

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 SOFR 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 SOFR 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.

Illustration 5-5: Derivative instruments – credit-linked notes

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.

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 SOFR-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 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, however the exercise price should be considered when determining whether the contract is a variable interest. 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.

VIE instrument	Description	Absorb variability related to:	
		Fair value	Cash flow ²⁰
Written put	Counterparty has an option to sell assets to the VIE	No ²¹	No ²¹
Written call	Counterparty has an option to purchase assets from the VIE	Yes	Yes
Purchased put	VIE has an option to sell assets to the counterparty	Yes	Yes
Purchased call	VIE has an option to purchase assets from the counterparty	No	No
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: <ul style="list-style-type: none"> ▸ Written put ▸ Purchased call 	No ²¹	No ²¹
Forward sell	VIE has entered into an arrangement to sell an asset at a fixed price ²² to the counterparty in the future. The derivative instrument can be bifurcated into a: <ul style="list-style-type: none"> ▸ 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 ²¹	No ²¹
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

²⁰ Under either the cash flow method or cash flow prime method.

²¹ 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.

²² 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.

See section 7.3.3 for guidance on how an option may affect an equity holder's right to receive an entity's expected residual returns when determining whether the equity holders as a group lack the characteristics of a controlling interest and whether an entity is a VIE.

Refer to ASC 810-10-55-62 through 86 for examples of determining the variability to be considered for certain contracts.

ASC paragraph	Example
ASC 810-10-55-62 through 64	Case B: financial VIE primarily financed by fixed-rate debt, holding investments in longer-term fixed- and variable-rate debt (with a fixed-rate swap)
ASC 810-10-55-65 through 67	Case C: financial VIE primarily financed by fixed-rate debt, holding investments in foreign-currency-denominated debt (with a currency swap)
ASC 810-10-55-68 through 70	Case D: financial VIE primarily financed by floating-rate debt, holding investments in fixed-rate securities
ASC 810-10-55-71 through 74	Case E: financial VIE financed by credit-linked notes holding highly rated floating-rate investments and a credit default swap
ASC 810-10-55-81 through 86	Case H: VIE holding both a fixed-price forward contract to buy and a fixed-price forward contract to sell electricity

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 Variable Interest 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 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 contracts 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 an 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 section 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 SOFR Overnight Index Swap rate (OIS) 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 section 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 SOFR OIS 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.

Derivatives – Embedded Derivatives

Recognition – General

815-15-25-1

An **embedded derivative** shall be separated from the host contract and accounted for as a **derivative instrument** pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

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

When identifying potential variable interests, a reporting entity determines whether to evaluate an embedded derivative separately from its host. To do so, it considers whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. When making this evaluation, the reporting entity considers the guidance in ASC 815-15-25-1 for determining whether an embedded derivative is "clearly and closely related" to its host. If it is clearly and closely related, the embedded derivative should be evaluated with the host (as a single instrument) when identifying variable interests.

Based on discussions with the FASB staff, we understand that when identifying variable interests, a reporting entity does not consider the other two criteria in ASC 815-15-25-1 that are used to determine whether to bifurcate an embedded derivative from the host contract. That is, only the guidance related to the first criterion in ASC 815-15-25-1 is relevant to the ASC 810 evaluation.

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. 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.

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 are generally 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. See section 3.3.1 of our FRD, ***Derivatives and hedging***, for more guidance on this second characteristic.
- ▶ 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 are clearly and closely related. However, a reset based on a change in another entity's credit rating or its default is not 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. See section 3.10.3 of our FRD, ***Derivatives and hedging***, for more guidance.
- ▶ 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. See section 3.8 of our FRD, ***Derivatives and hedging***, for additional guidance.
- ▶ 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.

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:

See section 5.4.7 for further guidance on determining whether leases are variable interests.

- ▶ Inflation-indexed rentals – Leasing assets and adjustments for inflation on similar property are clearly and closely related unless a significant leverage factor is involved.
- ▶ 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. However, options to extend the lease term at the current market rate for the asset are clearly and closely related.
- ▶ Contingent or variable lease payments based on lessee sales – Lease contracts that include contingent rentals based on certain sales of the lessee generally are clearly and closely related to the value of the leased asset.
- ▶ Contingent or variable lease payments 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) generally are 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 are not clearly and closely related. See section 5.4.5 for additional guidance on evaluating guarantees.
- ▶ 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 are not clearly and closely related. However, options allowing the lessee to acquire the leased asset at the asset's fair value at the option exercise date are clearly and closely related.

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 contracts

Purchase 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 purchase contract should be considered to determine whether the contract is a variable interest. First, we believe a purchase 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 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 in the contract should be compared with the volume of items purchased 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 contract, also need to be considered when evaluating the purchase 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.

	Contract pricing	
	Fixed	Fair value
Reporting entity purchases product from entity	Variable interest absorbs entity's variability ²³	Not a variable interest because there is no variability
Reporting entity sells product to entity	Not a variable interest; creates entity's variability	Not a variable interest because there is no variability

Determining whether a purchase 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 Leases

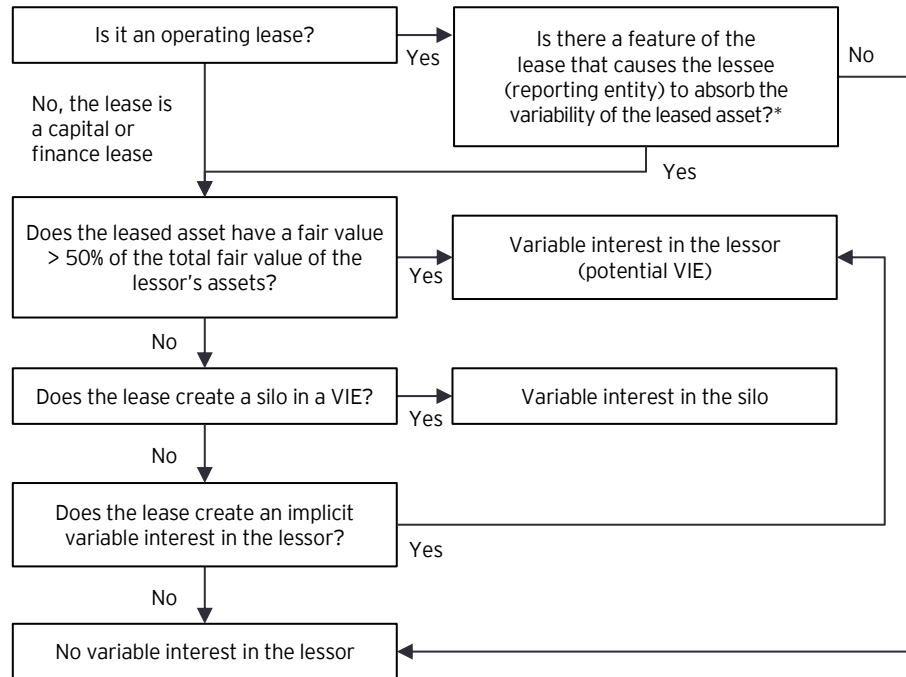
When evaluating whether a lessee reporting entity has a variable interest in the lessor, a lessee first determines whether the lease is an operating lease under ASC 840 or ASC 842,²⁴ as applicable. A lessor reporting entity also should evaluate whether it has a variable interest in the lessee entity. These concepts are discussed in more detail below.

A reporting entity also should consider whether the leasing relationship creates an implicit variable interest, as discussed in section 5.4.12.

²³ Except when the purchase contract is a derivative instrument that is determined not to be a variable interest in accordance with ASC 810-10-25-35 through 36.

²⁴ ASC 842 is effective for public business entities and not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and employee benefit plans that file or furnish financial statements with or to the SEC for annual periods beginning after 15 December 2018 and interim periods within those years. Private companies and private not-for-profit entities are required to adopt ASC 842 for annual reporting periods beginning after 15 December 2021 and interim reporting periods in annual reporting periods beginning after 15 December 2022. Not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market that have not issued (or made available for issuance) financial statements that reflect adoption of ASC 842 as of 3 June 2020 are required to adopt ASC 842 for annual reporting periods beginning after 15 December 2019 and interim reporting periods within those annual reporting periods.

The following flowchart illustrates how to think about whether a reporting entity that is a lessee has a variable interest in a legal entity that is a lessor:



* For example, a residual value guarantee or fixed-price purchase option.

5.4.7.1

Operating leases – reporting entity is the lessee

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.

Generally, we believe that operating leases do not create variable interests for lessees. 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 VIE'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 include provisions such as a residual value guarantee, fixed-price purchase option, fixed-price term-extending 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. See section 5.4.4.4 for examples of embedded derivatives in host lease instruments that may be variable interests.

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).

If the operating lease has a purchase option, a residual value guarantee or a similar feature that absorbs the variability of the leased asset, the lessee must determine whether the leased asset has a fair value that is more than half of the total fair value of a potential VIE’s assets.

- ▶ If yes, the lessee has a variable interest in the lessor. See sections 5.5 and 7.3.3.2 for additional guidance on variable interests in specified assets.
- ▶ If no, the lessee does not have a variable interest in the lessor, but the lessee should evaluate whether the lease creates a “silo” within a VIE (see section 6).
- ▶ If neither situation exists, the lessee does not have a variable interest.

Refer to ASC 810-10-55-78 through 80 and ASC 810-10-55-172 through 181 for an example of how a lessee reporting entity that accounts for its lease as an operating lease determines the variability to be considered when the lessor VIE accounts for the lease as a direct financing lease.

5.4.7.2 Capital leases and finance leases – reporting entity is the lessee

For lessee reporting entities, ASC 810 does not directly address whether a capital lease (under ASC 840) or finance lease (under ASC 842) represents a variable interest in the lessor. Generally, capital leases and finance leases absorb the variability of the leased asset. However, reporting entities that are lessees should consider the purpose and design of the lessor entity and the arrangement, and the variability that the lessor entity is expected to create, when making the determination of whether a capital lease or finance lease represents a variable interest in the lessor.

If the lessee reporting entity is absorbing the variability of the leased asset, it must determine whether the leased asset has a fair value that is more than half of the total fair value of the potential VIE’s assets.

- ▶ If yes, the lessee has a variable interest in the lessor. See sections 5.5 and 7.3.3.2 for additional guidance in variable interests in specified assets.
- ▶ If no, the lessee does not have a variable interest in the lessor, but the lessee should evaluate whether the lease creates a “silo” within a VIE (see section 6).
- ▶ If neither situation exists, the lessee does not have a variable interest.

See section 5.4.4.4 for examples of embedded derivatives in host lease instruments that may be variable interests.

5.4.7.3 Leases – reporting entity is the lessor

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, regardless of the lease classification. We believe that the lease interest is analogous to a debt interest, or a financing arrangement.

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 or ASC 842.

While ASC 840 and ASC 842 specifically exclude intangible assets from their scope, we believe that the operator of an LMA should determine whether, by analogy to ASC 840 or ASC 842, 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 features 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 may represent 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 contracts for real estate

We believe that a "typical" purchase contract for real estate that includes conditions prior to closing is usually not a variable interest, because, by design, it usually does not transfer to the buyer the benefits of ownership of the real estate before closing. This is consistent with the guidance in ASC 606 and ASC 610-20, which states that revenue and gains, respectively, should not be recognized until control has transferred to the buyer (i.e., when the sale closes). Therefore, the purchase contract generally will not cause the purchaser to consolidate the entity holding the real estate.

We believe a real estate purchase 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 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 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 believe a lot option contract to acquire land to be used in future construction by homebuilders usually is subject to the Variable Interest Model. See Appendix H for additional guidance.

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).

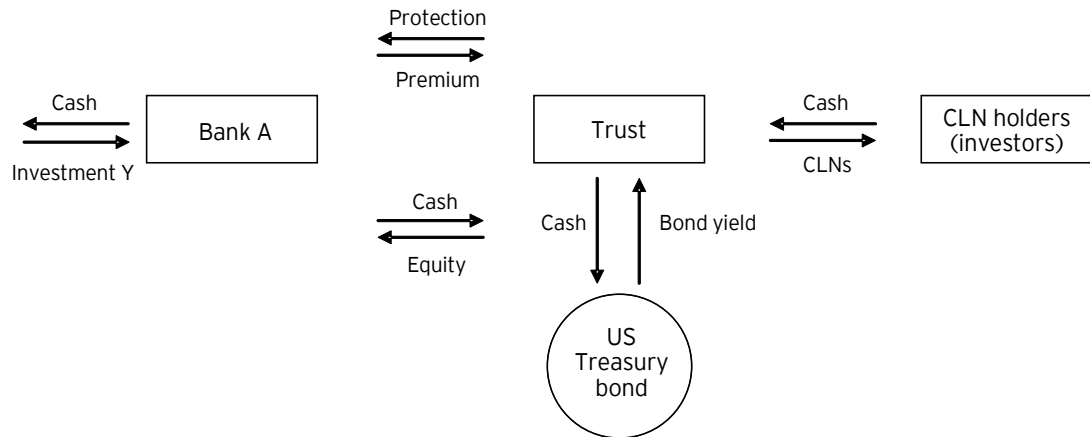
However, in certain circumstances the entity's design may lead to a conclusion that an instrument should be netted in applying the provisions of the Variable Interest Model.

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.

810-10-25-54

The reporting entity shall consider whether it holds an implicit variable interest in the VIE or potential VIE. The determination of whether an implicit variable interest exists shall be based on all facts and circumstances in determining whether the reporting entity may absorb variability of the VIE or potential VIE. A reporting entity that holds an implicit variable interest in a VIE and is a related party to other variable interest holders shall apply the guidance in paragraphs 810-10-25-42 through 25-44B to determine whether it is the primary beneficiary of the VIE. The guidance in paragraphs 810-10-25-49 through 25-54 applies to related parties as defined in paragraph 810-10-25-43. For example, the guidance in paragraphs 810-10-25-49 through 25-54 applies to any of the following situations:

- a. A reporting entity and a VIE are under common control.
- b. A reporting entity has an interest in, or other involvement with, a VIE and an officer of that reporting entity has a variable interest in the same VIE.
- c. A reporting entity enters into a contractual arrangement with an unrelated third party that has a variable interest in a VIE and that arrangement establishes a related party relationship.

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. Activities around the entity, such as relationships and transactions between a variable interest holder and a potential VIE or between two variable interest holders may create implicit variable interests.²⁵ These implicit variable 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.

²⁵ Comments by Jane D. Poulin, Associate Chief Accountant, at the 2004 AICPA National Conference on Current SEC and PCAOB Developments.

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.
- ▶ 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?

See section 9 for further guidance on identifying the primary beneficiary in a related party group, if the entity is determined to be a VIE.

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. The SEC staff stated that questions that should be considered in determining whether the reporting entity has an implicit variable interest in entities include²⁶:

- ▶ 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?

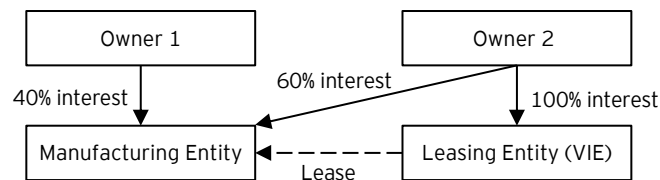
The determination of whether an implicit variable interest exists is based on facts and circumstances, requiring the use of professional judgment.

²⁶ Comments by Mark Northan, SEC Professional Accounting Fellow, at the 2005 AICPA National Conference on Current SEC and PCAOB Developments. We believe that references to FIN 46(R) in the speech also would apply to the current Variable Interest Model.

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)* and illustrates implicit variable interests.²⁷

Illustration 5-12: Implicit interests

One of the two owners of Manufacturing Entity, Owner 2, is also the sole owner of Leasing Entity, which is a VIE. Owner 2 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. Assume that 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 its relationship with Owner 2. For example, Manufacturing Entity would hold an implicit variable interest in Leasing Entity if Manufacturing Entity effectively guaranteed Owner 2's investment in Leasing Entity.

Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent Owner 2's guarantee of Leasing Entity's debt from being called on, or Manufacturing Entity may be expected to make funds available to Owner 2 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 Owner 2'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.

See section 5.4.7 for further discussion on determining whether leases are variable interests. See also section 8.2.3 on identifying the primary beneficiary for a single asset entity, if the leasing entity is determined to be a VIE.

²⁷ In practice, this example was often considered when evaluating whether an implicit interest exists. In conjunction with the issuance of ASU 2014-07, as discussed in paragraph BC23 of that ASU, 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 accounting alternative discussed in Appendix E. As discussed in paragraph BC24 of ASU 2018-17, the FASB did not intend for 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 for evaluating implicit variable interests.

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?

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 ASU 2015-02. The SEC staff also expressed a view in a December 2015 speech²⁸ 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 evaluate the provisions of the Variable Interest Model further with respect to its other interests.

²⁸ Comments by Christopher D. Semesky, SEC Professional Accounting Fellow, at the 2015 AICPA National Conference on Current SEC and PCAOB Developments.

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., determine 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.

Note: See ASC 810-10-55-205L through 205V for an example in which the general partner receives annual and performance-based fees and has a significant equity interest in a fund.

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.

Note: See ASC 810-10-55-205W through 205Y for an illustration in which the investment fund manager receives annual and performance-based fees but has no 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**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?

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 speech²⁹ 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.³⁰

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.

²⁹ Comments by Christopher D. Semesky, SEC Professional Accounting Fellow, at the 2015 AICPA National Conference on Current SEC and PCAOB Developments.

³⁰ See paragraphs BC75 and BC76 of ASU 2015-02.

Question 5.7 Should a “carried interest,” “incentive allocation” or a “promote” be included in the determination of whether a fee arrangement is a variable interest?

General partners are often eligible to receive as additional compensation for providing services enhanced returns if a fund’s performance achieves certain targets. These returns are often referred to as a “carried interest” in the financial services industry, an “incentive allocation” for hedge fund investment companies or a “promote” in the real estate industry. In many circumstances, a carried interest, incentive allocation or a promote is paid as an allocation after the limited partners receive a stated return. For example, a general partner with a small equity investment in a fund may receive 20% of the fund’s distributions after the other investors have earned a stated rate of return (i.e., once the limited partners achieve designated rates of return, the distributions allocated to the general partner are disproportionately greater than its equity interest in the fund).

When the general partner is entitled to a carried interest, incentive allocation or a promote as part of its fees for providing services, we believe that the carried interest or promote is considered in the determination of whether the fee arrangement is a variable interest. In other words, the general partner must determine that the fee arrangement, inclusive of the carried interest, incentive allocation or promote, meets the three criteria under ASC 810-10-55-37 explained above, to conclude that it is not a variable interest in the entity.

Question 5.8 If a decision maker or service provider waives its fees for a period (e.g., in the startup phase of a fund), are such fees viewed as customary and commensurate?

A manager may voluntarily waive fees that it has a contractual right to claim. A waiver may apply to all investors or to only a particular class of investors in a fund. A manager also may decide to waive fees rather than renegotiating them with investors (which may be difficult to accomplish in practice), making it easier to attract new investors.

It is important to understand the purpose and design of the arrangement when evaluating whether the fee arrangement is customary and commensurate. When fees are waived, the fees inclusive of the effects of fee waivers would be evaluated to determine if the fee arrangement is customary and commensurate. Factors to consider in evaluating fee arrangements and the related waivers could include whether the decision maker has a policy for waiving fees that is applied to similar funds, whether waivers are common in the industry or whether a one-time waiver has been granted. These factors are not all inclusive and facts and circumstances should be carefully evaluated when determining whether waivers are customary and commensurate.

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.

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.³¹ 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 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 (which differs from the evaluation of whether a reporting entity has "benefits" as discussed in section 8.3). 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 5.9

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.

³¹ See paragraph A76 of FAS 167.

In contrast, we believe that the assessment of significance as part of the primary beneficiary determination contemplates possible outcomes, as discussed in section 8.3. 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 5.10 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 5.11 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.

Question 5.12 How should the sponsor of a special-purpose acquisition company (SPAC) consider the capital that it contributes at formation?

A SPAC is a blank-check company that raises capital from investors in an IPO to use in the future to acquire a target that has not been identified at the time of the IPO. Upon formation, a SPAC is initially capitalized by sponsors, who contribute nominal capital or fund the formation and offering costs in exchange for founder shares that typically make up 20% of the shares of the company after the IPO, assuming the underwriters don't exercise an overallotment option. The SPAC then files an initial registration statement on Form S-1 with the SEC to conduct its IPO. The SPAC then identifies one or more operating company targets for acquisition. These operating companies are usually privately held companies that use the SPAC merger to become publicly traded companies. A SPAC generally has 18 to 24 months from the date of its IPO to acquire a target, depending on the provisions of its charter documents. See our Technical Line publication, *[Navigating the requirements for merging with a special purpose acquisition company](#)*, for more discussion on the structure and life cycle of a SPAC.

In some cases, a sponsor of a SPAC acts as a decision maker or has the ability to select the individuals making decisions (1) in the period after formation but before the IPO, (2) after the IPO but before the acquisition occurs or (3) after the acquisition occurs. In these cases, the sponsor should consider the contributed capital as “seed money,” as discussed in Question 5.10, and should evaluate whether it is the primary beneficiary of the SPAC during these periods, as discussed in section 8.2.3.6.1. Judgment should be used to evaluate the facts and circumstances. The formation, governance and the sponsor’s role as a decision maker may vary.

This guidance also may apply to other capital structures in which an entity is created and funded for a special purpose (e.g., to identify a target acquisition) as seen in a variety of industries, including the real estate industry.

5.4.13.2.1

Interests held by related parties when evaluating fees paid to a decision maker or service provider (updated June 2023)

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

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

When evaluating whether the fees paid to a decision maker or service provider are a variable interest, interests in the legal entity held by a related party³² of the decision maker or service provider should be considered in the analysis. Accordingly, a decision maker or service provider includes its direct and indirect interests in a legal entity.

A decision maker or service provider has an indirect interest in a legal entity when it has a direct variable interest in a related party that has a variable interest in the legal entity. For example, if reporting entity A, which is the decision maker for legal entity C, has a 20% interest in related party entity B, which has a 10% interest in legal entity C, then reporting entity A has an indirect interest in legal entity C. However, if

³² In this context, related parties include de facto agents of the reporting entity. See section 10 for the Variable Interest Model’s definition of related parties and de facto agents.

a decision maker or service provider has a direct variable interest in an unrelated party that has a variable interest in the legal entity, the interest in the unrelated party is not considered an indirect interest that needs further consideration.

ASU 2018-17 changed how indirect interests held through related parties that are under common control with the decision maker generally are considered when evaluating whether the fees paid to a decision maker or service provider are a variable interest. Today, indirect interests generally are included on a proportionate basis rather than in their entirety, as was previously the case. The following table summarizes how indirect interests held by a decision maker or service provider generally are evaluated. See section 2.3 for the definition of common control.

	No indirect interest	Indirect interest
Not related parties	Not included in evaluation	Not included in evaluation
Related parties not under common control (see Illustrations 5-16 and 5-17)		Proportionate basis
Related parties under common control (see Illustrations 5-18 and 5-19)		

When one of the variable interests is other than an equity interest that absorbs variability on a pro rata basis (e.g., a loan, a guarantee, an equity interest with a preferential return), it may not always be clear how such interests should be considered in the evaluation of whether the fees paid to a decision maker or service provider are a variable interest. We believe that the following factors should be considered when determining how to consider the indirect interest:

- ▶ Purpose and design of the entity
- ▶ Nature of the interests held
- ▶ Variability absorbed

The SEC staff stated in a December 2015 speech³³ that when a decision maker or service provider does **not** have a variable interest in the related party, the variable interests in the legal entity that are held by its related party are not included when considering the significance of the decision maker's interests, 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 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.

³³ Comments by Christopher D. Semesky, SEC Professional Accounting Fellow, at the 2015 AICPA National Conference on Current SEC and PCAOB Developments.

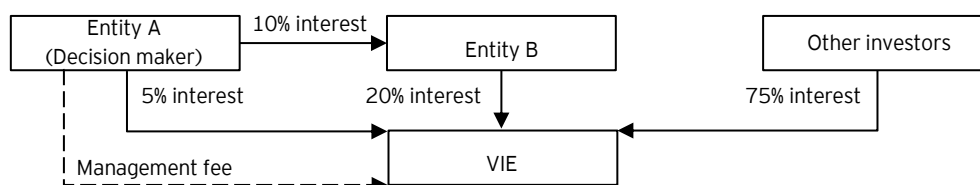
Additionally, the SEC staff observed that once the manager determined that it does not have a variable interest in the entity, it would not be required to consolidate the entity as a result of applying the related party tiebreaker test, as discussed in section 9.2.

We believe the SEC staff's comments about evaluating whether an entity is designed to separate power from economics to avoid consolidation in the separate company financial statements of a decision maker continue to be relevant after the adoption of ASU 2018-17. When assessing whether an arrangement has substance, we believe it is important to understand the factors included above (i.e., purpose and design, nature of interests held and variability absorbed).

The following illustrations show the application of ASC 810-10-55-37D.

Illustration 5-16: Related parties not under common control with an indirect interest

Entity A, the decision maker, has a 5% direct equity 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% equity 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. All the interests absorb variability on a pro rata basis and the structure was not designed to avoid consolidation of the VIE by Entity A.

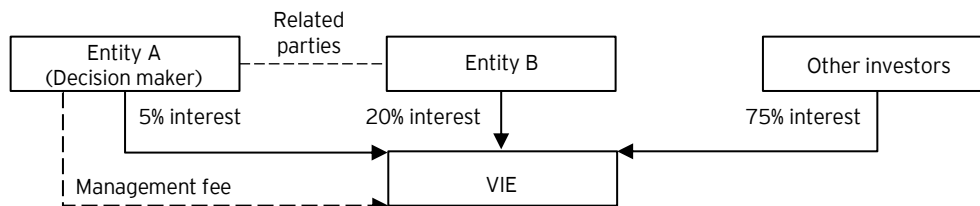


Analysis

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%)) since Entity A and Entity B are related parties, the interests absorb variability on a pro rata basis and the structure was not designed to avoid consolidation of the VIE by Entity A.

Illustration 5-17: 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.

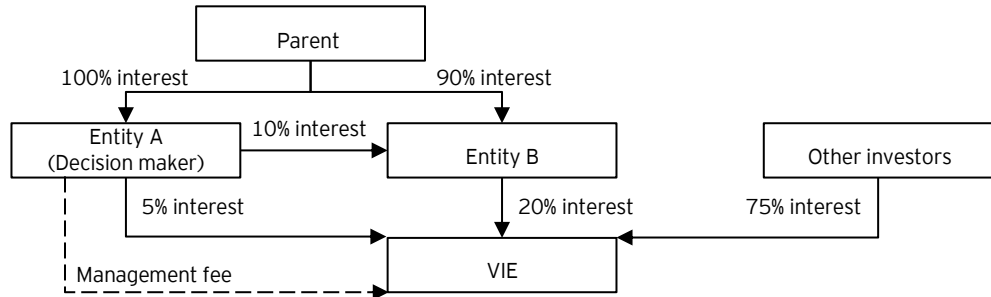


Analysis

We believe that the decision maker's total other interests for determining whether its fee is a variable interest would be 5% because the interests absorb variability on a pro rata basis and the structure was not designed to avoid consolidation of the VIE by Entity A. There are no indirect interests.

Illustration 5-18: 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.



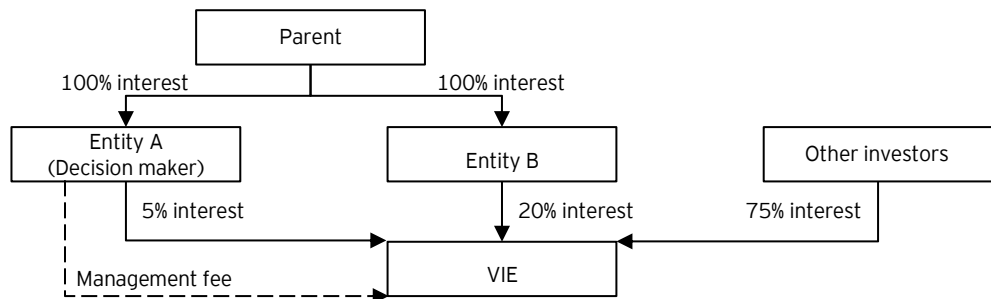
Analysis

We believe that the decision maker’s total other interests for determining whether its fee is a variable interest would be 7% (i.e., 5% direct + 2% indirect interest). The 2% indirect interest is Entity A’s proportionate share of Entity B’s interest (i.e., 10% x 20%). Entity A’s indirect interests are included on a proportionate basis since Entity A and Entity B are related parties, the interests absorb variability on a pro rata basis and the structure was not designed to avoid consolidation of the VIE by Entity A.

This illustration focuses on whether Entity A has a variable interest in the VIE. See section 9.2 for guidance on how to determine whether Parent would consolidate the VIE.

Illustration 5-19: 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% because the interests absorb variability on a pro rata basis and the structure was not designed to avoid consolidation of the VIE by Entity A. There are no indirect interests.

This illustration focuses on whether Entity A has a variable interest in the VIE. See section 9.2 for guidance on how to determine whether Parent would consolidate the VIE.

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 Variable Interest 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

Excerpt from Accounting Standards Codification

Consolidation – Overall

Implementation Guidance and Illustrations – Variable Interest Entities

810-10-55-37C

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

- a. Those related to guarantees of the value of the assets or liabilities of a VIE
- b. Obligations to fund operating losses
- c. Payments associated with written put options on the assets of the VIE
- d. Similar obligations, such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE.

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

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 that the VIE was designed to create and pass through to its variable interest holders are not eligible for evaluation using the conditions in ASC 810-10-55-37. Rather, such fees or arrangements are variable interests, even if they are commensurate with the level of effort required to provide those services (i.e., at market) and include only customary provisions.

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

- ▶ Guarantees and certain credit enhancements (see section 5.4.5)
- ▶ Obligations to fund operating losses (see section 5.4.5)
- ▶ Payments associated with written put options on the assets of the VIE (see section 5.4.5)
- ▶ Liquidity commitments and similar obligations (explicit or implicit), such as repurchase provisions (see section 5.4.5, section 5.4.12 and Illustration 5-22), that protect holders of other interests from suffering losses in the VIE
- ▶ Certain derivative instruments (see section 5.4.4.1)
- ▶ Certain forward contracts (see section 5.4.4.2)

As discussed in paragraph BC42 of 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.

See section 7.3.2.1 for additional examples of common arrangements that may expose a reporting entity to risk of loss.

Illustration 5-20: Standard representations and warranties

Company A sponsors a trust and transfers loans into the trust with the intent of securitizing the loans. The trust issues beneficial interests in the transferred loans, of which Company A retains 5% of each class of interests (i.e., a vertical risk retention interest), which it concludes would not absorb more than an insignificant amount of the trust's expected losses or receive more than an insignificant amount of the trust's expected residual returns.

Company A also is the servicer of the loans for the trust and receives a fee for these services that is customary and commensurate. Company A does not have other variable interests in the trust. The trust was designed to expose the variable interest holders to the credit risk of the loans.

Company A provides a standard representation and warranty for the transferred loans at the date of transfer into the trust. In the context of ASC 860, standard representations and warranties are defined in the ASC Master Glossary as "representations and warranties that assert the financial asset being transferred is what it is purported to be at the transfer date."

Examples include representations and warranties about (1) the characteristics, nature and quality of the underlying financial asset, including characteristics of the underlying borrower and the type and nature of the collateral securing the underlying financial asset; (2) the quality, accuracy and delivery of documentation relating to the transfer and the underlying financial asset; and (3) the accuracy of the transferor's representations in relation to the underlying financial asset. Representations and warranties generally last for the life of the transferred financial assets.

The investors in the trust have no recourse to Company A other than for a breach of standard representations and warranties.

Analysis

A standard representation and warranty about the terms and conditions of the loans on the date of transfer into the trust do not expose Company A to the risks the trust was designed to create and pass through to its variable interest holders (credit default after transfer into the trust). Rather, the contractual term relates to the terms and conditions under which the loans were written (i.e., discrete events that occurred before the securitization and that are clearly separable from the ongoing credit risk of the loans).

Therefore, since the fee is customary and commensurate and does not expose Company A to risk of loss, and Company A does not have other variable interests that would absorb more than an insignificant amount of the trust's expected losses or receive more than an insignificant amount of the trust's expected residual returns, the fee is not a variable interest.

Illustration 5-21: Contingent removal-of-account provision in a securitization

Company B sponsors a trust and transfers loans into the trust with the intent of securitizing the loans. The trust issues beneficial interests in the transferred loans, of which Company B retains 5% of each class of interests (i.e., a vertical risk retention interest), which it concludes would not absorb more than an insignificant amount of the trust's expected losses or receive more than an insignificant amount of the trust's expected residual returns.

Company B is the servicer of the loans for the trust and receives a fee for these services that is customary and commensurate. Company B does not have other variable interests in the trust. The trust was designed to expose the variable interest holders to the credit risk of the loans.

Company B has the ability to reclaim the loans (e.g., the right to specify the assets to be removed from the trust) subject to certain restrictions at par value, but **it is not required** to do so. Such a right is commonly referred to as a removal-of-accounts provision (ROAP). Assume that in this example the ROAP can be exercised only in response to a third party's action that has not yet occurred, such as a default (i.e., it is a contingent ROAP).

The investors in the trust have no recourse to Company B if it does not exercise the ROAP.

Analysis

The contingent ROAP, which gives Company B the ability but not the obligation to reclaim loans, does not expose Company B to the risks the trust was designed to create and pass through to its variable interest holders (credit risk after transfer into the trust). This is because Company B is not required to repurchase the loans when the contingent event occurs. However, in reaching that conclusion, Company B should carefully evaluate the substantive terms of the arrangement to determine whether it has an implicit obligation. Marketing and other investment materials should be reviewed carefully as part of the evaluation. See section 5.4.7 for more guidance on implicit variable interests.

Therefore, if the fee is customary and commensurate and does not expose Company B to risk of loss (considering explicit and implicit obligations), and Company B does not have other variable interests in the trust that would absorb more than an insignificant amount of the trust's expected losses or receive more than an insignificant amount of the trust's expected residual returns, the fee is not a variable interest.

See section 5.4.2 of our FRD, *Transfers and servicing of financial assets*, for guidance on evaluating these provisions under ASC 860.

Illustration 5-22: Required repurchase provision in a securitization

Company C sponsors a trust and transfers loans into the trust with the intent of securitizing the loans. The trust issues beneficial interests in the transferred loans, of which Company C retains 5% of each class of interests (i.e., a vertical risk retention interest), which it concludes would not absorb more than an insignificant amount of the trust's expected losses or receive more than an insignificant amount of the trust's expected residual returns.

Company C is the servicer of the loans for the trust and receives a fee for these services that is customary and commensurate. Company C does not have other variable interests in the trust. The trust was designed to expose the variable interest holders to the credit risk of the loans.

However, if a loan is modified due to a default and not due to a breach of standard representations and warranties, as discussed in Illustration 5-20, Company C **must** buy the loan out of the trust at par (i.e., the purchase is not optional).

Analysis

Fees that expose a service provider to risk of loss are automatically variable interests. Because the trust was designed to create and pass along credit risk to its variable interest holders, the repurchase provision absorbs that risk and protects the other variable interest holders from absorbing that risk, since Company C is **required** to repurchase the loans at par (which would exceed fair value) upon a credit default. Therefore, the fee exposes Company C to “risk of loss,” and its fee is a variable interest.

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 in the entity’s status as a VIE³⁴ (see section 12 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

³⁴ See paragraphs D36 and D39 of FAS 167.

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.

5.5

Variable interests in specified assets

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 5-23: 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.

Pending Content:

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

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 5-24: 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:

Illustration 5-25: Interest in specified assets and effect on calculation of entity's expected losses

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):

Possible outcome	Estimated cash flows	Probability	Expected cash flows	Expected losses	Expected residual returns
	(a)	(b)	(a) x (b) = c	((a) - \$840) x b	((-\$840 - a) x b)
1	\$ 1,000	50%	\$ 500	\$ -	\$ 80
2	800	35%	280	14	-
3	400	15%	60	66	-
			<u>\$ 840</u>	<u>\$ 80</u>	<u>\$ 80</u>

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 interest in specified assets	<u>45</u>
Entity's expected losses	<u>\$ 285</u>

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 section 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 Variable Interest Model (see section 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, and can be consolidated separately from the 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 owns two buildings, and each one is leased to an unrelated third party (i.e., Building A is leased to Company A and Building B to Company B). Company A has a fixed-price purchase option that allows it to purchase Building A for \$120. No such option exists for Building B. Assume that the leases meet the classification requirements to be operating leases.

The lessor's balance sheet is as follows (on a fair value basis):

Assets		Liabilities and equity	
Cash	\$ 20	Debt (recourse only to Building A)	\$ 120
Building A (leased to Company A)	120	Debt (recourse only to Building B)	50
Building B (leased to Company B)	<u>100</u>	Equity	<u>70</u>
Total assets	<u>\$ 240</u>	Total liabilities and equity	<u>\$ 240</u>

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. Assume that the leases meet the classification requirements to be operating leases.

The lessor's balance sheet looks as follows at the inception of the leasing arrangements (on a fair value basis):

Assets		Liabilities and equity	
Building A (leased to Company A)	\$ 100	Debt (Recourse to the Entity)	\$ 290
Building B (leased to Company B)	100		
Building C (leased to Company C)	<u>100</u>	Equity	<u>10</u>
Total assets	<u>\$ 300</u>	Total liabilities and equity	<u>\$ 300</u>

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. Assume that the leases meet the classification requirements for to be operating leases.

The lessor's balance sheet is as follows at the inception of the leasing arrangements (on a fair value basis):

Assets		Liabilities and equity	
Building A (leased to Company A)	\$ 100	Nonrecourse Debt – Building A	\$ 96
Building B (leased to Company B)	100	Nonrecourse Debt – Building B	96
Building C (leased to Company C)	100	Nonrecourse Debt – Building C	96
		Equity	<u>12</u>
Total assets	<u>\$ 300</u>	Total liabilities and equity	<u>\$ 300</u>

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. Assume that the leases meet the classification requirements to be operating leases.

The lessor's balance sheet looks as follows at the inception of the leasing arrangements (on a fair value basis):

Assets		Liabilities and equity	
Cash	\$ 6	Nonrecourse Debt – Building A	\$ 94
Building A (leased to Company A)	100	Nonrecourse Debt – Building B	94
Building B (leased to Company B)	100	Nonrecourse Debt – Building C	94
Building C (leased to Company C)	100	Deferred Revenue – Building A	6
		Equity	<u>18</u>
Total assets	<u>\$ 306</u>	Total liabilities and equity	<u>\$ 306</u>

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

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. When determining if the entity is a VIE and evaluating whether the equity holders have the characteristics of a controlling financial interest as discussed in section 7.3.1, the silos should be excluded. Without requiring a silo to be separated from the VIE host entity, the same assets and liabilities could be consolidated by two parties, which would be 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. (lessor) owns two buildings. Building A is leased to Company A 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 that the leases meet the classification requirements for an operating lease.

Lease Co.’s balance sheet is as follows (on a fair value basis):

Assets		Liabilities and equity	
Cash	\$ 5	Debt (recourse only to Building A)	\$ 100
Building A (leased to Company A)	120	Debt (recourse only to Building B)	97
Building B (leased to Company B)	<u>100</u>	Equity	<u>28</u>
Total assets	<u>\$ 225</u>	Total liabilities and equity	<u>\$ 225</u>

Assume expected losses of Lease Co. 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 D 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 section 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 that the lease meets the classification requirements for an operating lease.

The entity's balance sheet at the inception of the leasing arrangement is as follows (on a fair value basis):

Assets		Liabilities and equity	
Building (leased to Company A)	\$ 100	Nonrecourse Debt – Lender A	\$ 50
Other assets	300	Nonrecourse Debt – Lender B	50
		Other liabilities	280
		Equity	<u>20</u>
Total assets	<u>\$ 400</u>	Total liabilities and equity	<u>\$ 400</u>

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):

Assets		Liabilities and equity	
Cash	\$ 5	Debt (recourse only to Building A)	\$ 100
Building A (leased to Company A)	120	Debt (recourse only to Building B)	100
Building B (leased to Company B)	100	Debt (recourse only to Building C)	97
Building C (leased to Company C)	<u>100</u>	Equity	<u>28</u>
Total assets	<u>\$ 325</u>	Total liabilities and equity	<u>\$ 325</u>

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.).

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 section 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.

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):

Assets		Liabilities and equity	
Cash	\$ 5	Debt (recourse only to Building A)	\$ 100
Building A (leased to Company A)	120	Debt (recourse only to Building B)	100
Building B (leased to Company B)	100	Debt (recourse only to Building C)	388
Building C (leased to Company C)	<u>400</u>	Equity	<u>37</u>
Total assets	<u>\$ 625</u>	Total liabilities and equity	<u>\$ 625</u>

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.).

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 upon becoming 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 section 11 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 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).

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
- ▶ 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
- ▶ Equity-classified warrants to purchase equity interests
- ▶ LLC member interests
- ▶ General partnership interests

- ▶ Limited partnership interests
- ▶ Certain beneficial interests in trusts

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 section 5). See section 7.2.3.2 for additional guidance on how commitments may be considered when evaluating whether an entity can finance its own activities without additional subordinated support.

Question 7.2 Are amounts reported in other comprehensive income (e.g., amounts arising from hedge accounting pursuant to ASC 815) 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.³⁵ 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.

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.

³⁵ Generally, this is demonstrated through testing performed by independent laboratories and chemists.

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 D.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.

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 entity. 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:

	Ownership %	Fair value (\$ millions)
Oilco	33.3%	\$ 33.3
Gasco	33.3%	33.3
Drillco	33.3%	33.3

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. See our FRD, [Business combinations](#), for additional guidance.

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:

	<u>Option 1</u>	<u>Option 2</u>
Asset value	\$ 100	\$ 100
Option's strike price	\$ 130	\$ 80
Option's fair value (assumed)	\$ 15	\$ 35

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.

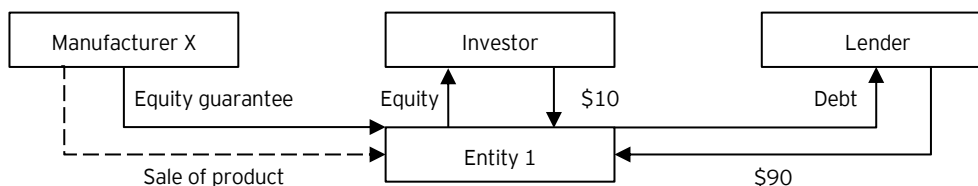
As stated in ASC 810-10-15-14(a)(3) and (4), the total equity investment at risk does not include amounts provided to or financed for the equity investor **directly by the legal entity or by other parties involved with the legal entity** [emphasis added].

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 speech³⁶ 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 Variable Interest Model. While this speech was intended to address accounting under FIN 46(R), we believe that the concepts remain relevant.

Illustration 7-8: Transactions outside the entity

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 Entity 1 may put the equity to Manufacturer X for \$10 at a future date, effectively guaranteeing the equity. The transaction is illustrated as follows:



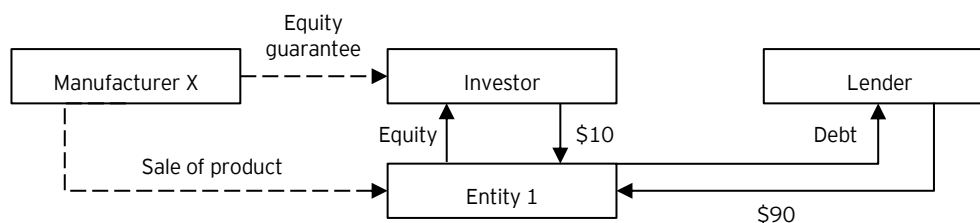
Analysis

We believe the equity investment is not at risk because it does not participate significantly in losses of the entity. Accordingly, because there is no equity investment at risk, the entity would be a VIE.

³⁶ Comments by Jane D. Poulin, Associate Chief Accountant, at the 2004 AICPA National Conference on Current SEC and PCAOB Developments.

Illustration 7-9: Transactions outside the entity

Assume the same facts as Illustration 7-8, except that 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

At risk factor	Example 1	Example 2	Example 3
1. Do the equity holders significantly participate in profits and losses of the entity?	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 of the entity. ABC's equity investment significantly participates in profits and losses.	Possibly. See Example 1.	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.
2. Does equity include equity interests issued in exchange for subordinated interests in other VIEs?	Yes. ABC Enterprises' equity investment meets this criterion. Accordingly, its equity investment is not at risk.	No.	No.
3. Has any amount of equity been provided to the equity investor directly by the entity or by other parties involved with the entity?	No.	No.	No.
4. Has any amount of equity been financed directly by the entity or by other parties involved with the entity?	No.	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.	No. See Example 2.
5. Conclusion	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.	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.	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.

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. The FASB's intent was to emphasize that the 3% equity presumption that existed before the development of the Variable Interest Model was superseded.³⁷

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. Therefore, we 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 investment at risk 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 equity investment at risk is sufficient should be made after consideration of all facts and circumstances, based on the purpose and design of the entity.

Illustration 7-12: Demonstrating whether the amount of equity is sufficient

A real estate partnership that operates a property has an initial equity investment representing 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 partnership 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 partnership 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 partnership 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).

³⁷ See paragraph E23 of FIN 46(R).

As discussed in Question 7.1, commitments to fund losses or contribute equity are not considered equity investments at risk because they are not reported as equity in the GAAP balance sheet of the entity. Accordingly, a reporting entity should consider them carefully when determining whether the equity investment at risk is sufficient. While not determinative, a commitment to fund losses or contribute equity could indicate that the equity investment at risk is insufficient.

Commitments to fund losses or future equity are common when an entity is expected to have different stages. We believe that a reporting entity should evaluate the nature of the stages and the probability of successfully moving from one stage to the next when evaluating whether the equity at risk is sufficient. We generally believe that the greater the certainty of the completion of the stage, the more likely that a reporting entity would look beyond that stage and consider other stages of the entity's life cycle when assessing whether an entity has sufficient equity at risk. See section 7.2.4 for guidance on development stage entities.

In addition, issuing new commitments to fund an entity or contributing additional cash to an entity in fulfillment of a previous commitment may indicate that a reconsideration event has occurred, in which case the reporting entity would reevaluate whether the entity is a VIE, as discussed in section 12.1.

The assessment of whether an entity has sufficient equity at risk is based on the facts and circumstances and the entity's purpose and design, and it will require the use of professional judgment. See sections 5.2.1, 5.2.2, and 7.3.1.1 for additional guidance on considering an entity's purpose and design.

Illustration 7-13: Evaluating a commitment to fund clinical development of a drug

Pharma A and Investor B form Biotech Z, the legal entity being evaluated for consolidation, to develop a drug candidate. Investor B contributes \$20 million in cash and Pharma A contributes \$20 million in IPR&D (see Question 7.6) in exchange for equity in Biotech Z. The purpose of Biotech Z is to take the drug candidate through clinical development. If Biotech Z needs additional funding to complete clinical development, Pharma A and Investor B have committed to provide additional cash in exchange for additional equity in Biotech Z.

Analysis

Because Pharma A and Investor B have committed to fund additional cash that would be used by Biotech Z for clinical development of the drug, this commitment indicates that Biotech Z may have insufficient equity at risk to finance the purpose for which it was designed (i.e., clinical development of the drug candidate). See section 7.2.4 for additional guidance on development stage entities.

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
 - ▶ Exposure to interest rate risk

- ▶ Type and duration
- ▶ Concentration
- ▶ Credit quality
- ▶ Liquidity
- ▶ Capitalization
 - ▶ Type and amount of debt/equity
 - ▶ Terms of instruments
 - ▶ Priority and liquidation preferences
 - ▶ Maturities of debt
- ▶ Nature of operations
 - ▶ Geographic area(s)
 - ▶ Scale
 - ▶ Product line(s)
 - ▶ Service line(s)
 - ▶ Cash flows
- ▶ Other
 - ▶ Derivatives
 - ▶ Risk management contracts
 - ▶ Regulatory capital requirements

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 while meeting the minimum capital requirements imposed by a regulator may provide corroborative evidence to assist in determining the sufficiency of the equity investment at risk in a financial institution, such as a bank or insurance company, it is not determinative. We understand that the FASB decided not to require an equity investment of at least 10% of assets (as discussed in section 7.2.3.1) partly because of regulatory requirements that allow financial institutions to operate at capital levels that are less than 10% of their total assets.

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 D 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 section 5 and Appendix D 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.



FASB update

In November 2019, the FASB proposed amendments that, among other changes, would remove references to Concepts Statement No. 7 from the definition of "expected losses and expected residual returns" in ASC 810-10-20. The FASB does not intend³⁸ for the changes to have a significant effect on current practice.

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.

³⁸ Paragraph 4 of Proposed ASU, *Codification Improvements*.

Illustration 7-14: 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 7-15: 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:

Total assets	\$ 12.0 million
Bank loan	9.0 million
Other liabilities	1.9 million
Partners' capital	1.1 million

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 D).

Illustration 7-16: 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**

When determining whether a development stage entity's equity at risk is sufficient to finance its activities, a reporting entity should carefully consider the entity's purpose and design. By design, some entities may be intended only to reach one stage in development whereas other entities may be designed to achieve several stages of development. See section 8.2.3.6.1 for guidance on identifying the primary beneficiary for VIEs when different parties have power over the VIE's life cycle and section 12.1 for guidance on when to reconsider whether an entity is a VIE.

7.3**The equity holders, as a group, lack the characteristics of a controlling financial interest**

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 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)

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

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:
 - ▶ 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 a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A **decision maker** also shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 810-10-55-37 through 55-38.

- ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists. The guidance in this subparagraph does not apply to entities in industries (see paragraphs 910-810-45-1 and 932-810-45-1) in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).
 - 01. A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive **kick-out rights** (according to their voting interest entity definition) through voting interests over the general partner(s).
 - A. For purposes of evaluating the threshold in (01) above, a general partner's kick-out rights held through voting interests shall not be included. Kick-out rights through voting interests held by entities under common control with the general partner or other parties acting on behalf of the general partner also shall not be included.
 - 02. Limited partners with equity at risk are able to exercise substantive **participating rights** (according to their voting interest entity definition) over the general partner(s).
 - 03. For purposes of (01) and (02) above, evaluation of the substantiveness of participating rights and kick-out rights shall be based on the guidance included in paragraphs 810-10-25-2 through 25-14C ...

If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE ...

The owners of the equity investment at risk should be able to make decisions that most significantly impact 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. The guidance in ASC 810-10-15-14(b)(1)(ii) does not apply to entities in industries in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership. See section 14.2 for additional guidance.

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:



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 section 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 (updated June 2023)

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 (e.g., accounting). Rather, power must enable these equity holders to make substantive decisions about the activities that most significantly impact the economic performance of the entity. These activities are identified by considering the risks that the entity was designed to create and pass through to its variable interest holders.

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). The significant activities identified will differ by the type, industry (see section 7.3.1.2.1) and operations of the entity being evaluated and require significant judgment, based on the facts and circumstances. Examples of substantive decisions that affect economic performance **may** include the ability to:

- ▶ Purchase or sell significant assets
- ▶ Enter new lines of business or expand the entity's goods or services
- ▶ Incur significant additional indebtedness or issue significant additional equity
- ▶ Approve operating and capital budgets
- ▶ Hire, fire and compensate management
- ▶ Make acquisition and/or divestiture decisions
- ▶ Determine the strategic operating direction of the entity
- ▶ Establish a marketing and sales strategy

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 identify the activities that most significantly impact the economic performance of the entity. In doing so, careful consideration is required regarding the purpose and design of the entity. In addition, the identification of significant activities 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 identification of the significant activities. See section 8.2.2 and Question 8.2 for additional guidance on identifying significant activities for entities that are believed to have no ongoing substantive decision making.

We believe that the assessment of the significant activities of an entity 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 section 8.2.2). In some cases, the significant activities of an entity may change at various stages over an entity's life cycle. In these cases, 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 in determining the significant activities. 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. See section 8.2.3.6.1 for guidance on identifying the primary beneficiary when different parties have power over the entity's life cycle.

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.

7.3.1.2.1

Industry examples of significant activities (added June 2023)

Examples of substantive decisions that may represent industry-specific activities that most significantly affect an entity's economic performance include:

Industry	Industry-specific activities
Airline	<ul style="list-style-type: none"> ▶ Approving the purchase or sale of aircraft ▶ Negotiating contracts with airports ▶ Identifying flight routes ▶ Investing in partnership airlines ▶ Participating and investing in fuel consortia at airports
Financial services – asset management	<ul style="list-style-type: none"> ▶ Developing the entity's investment strategy ▶ Purchasing and selling underlying investments ▶ Exercising voting rights in investees ▶ Negotiating key service provider contracts
Financial services – securitization vehicles	<ul style="list-style-type: none"> ▶ Servicing (workout) loans or other assets held as collateral that are delinquent or in default ▶ Identifying, negotiating and purchasing assets held as collateral
Financial services – banking	<ul style="list-style-type: none"> ▶ Performing lending activities ▶ Performing loan servicing activities ▶ Performing deposit activities ▶ Performing treasury management services
Financial services – insurance	<ul style="list-style-type: none"> ▶ Establishing underwriting standards ▶ Directing investment strategy ▶ Determining claim settlement practices and procedures ▶ Developing capital and risk management strategies ▶ Designing reinsurance strategies ▶ Hiring and firing of third-party administrators

Industry	Industry-specific activities
Healthcare (providers)	<ul style="list-style-type: none"> ▶ Negotiating provider and payor contracts ▶ Establishing patient care policies and protocol ▶ Providing patient care ▶ Approving cost initiatives
Life sciences	<ul style="list-style-type: none"> ▶ Performing research and development ▶ Establishing a marketing and sales strategy (i.e., commercialization and production of approved drug compounds, biologics and new medical technologies) ▶ Developing, manufacturing or directing the production of the drug, biologic or medical technology
Media and entertainment (e.g., film, publishing, radio and television)	<ul style="list-style-type: none"> ▶ Negotiating retransmission agreements ▶ Establishing programming and content ▶ Determining advertising strategies and negotiating advertising agreements
Real estate	<ul style="list-style-type: none"> ▶ Approving significant leases and related terms (e.g., selection of tenants, establishing rental rates) ▶ Approving significant contracts (e.g., property management agreement) ▶ Deciding to buy or sell real estate assets ▶ Deciding the scope of any development or redevelopment work ▶ Determining, amending or changing the capital structure of the entity (e.g., number of investors, capital requirements, allocation of profits and losses)
Retail, consumer and industrial products	<ul style="list-style-type: none"> ▶ Developing new products ▶ Negotiating supply contracts ▶ Establishing and executing a manufacturing strategy (e.g., determining quantities of product to produce and sourcing of raw material)
Technology	<ul style="list-style-type: none"> ▶ Performing research and development, including commercialization ▶ Determining how to develop, manufacture, assemble and/or provision the product (e.g., software development activities, semiconductor device fabrication)

7.3.1.3 **Step 3: Determine 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 determine 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 paragraphs BC35 and BC36 of 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.

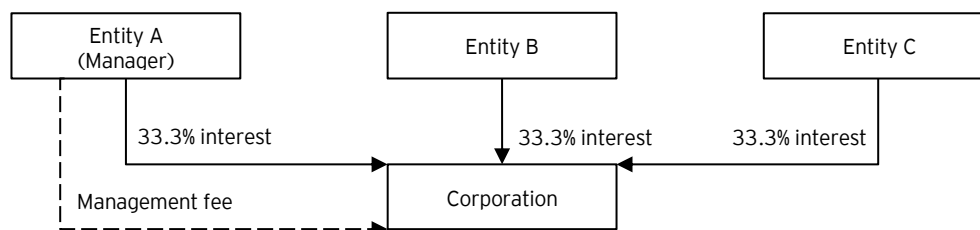
If the equity holders do not have power through voting rights in their equity-at-risk interests over the activities of a legal entity that most significantly impact the entity's economic performance, the second step of the analysis must be performed to evaluate whether there is a decision maker that 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 7-17: 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. Entity A can sell its equity interest and retain its management contract (and vice versa), that is, they are separable. 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 7-18: Power through equity investments at risk

In contrast to the structure in Illustration 7-17, 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 7-17. 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. See section 7.3.1.3.3 for guidance about evaluating whether kick-out rights are substantive. See section 7.3.1.3.4 for guidance on evaluating participating rights.

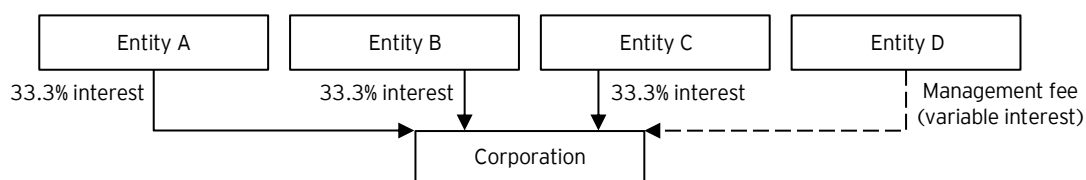
For example, assume a non-equity holder believes it has the power to direct the activities that most significantly impact the entity's economic performance such that it would appear that the entity may be a VIE. However, if equity holders with a simple majority of voting interests have the ability to 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 8H (see section 4.2.7 for excerpt), 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 7-19: VIE determination: evaluation of the rights held by the equity holders over an operations manager

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 an operations 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 (assuming that none of the other criteria are violated). 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 equity investors) 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.

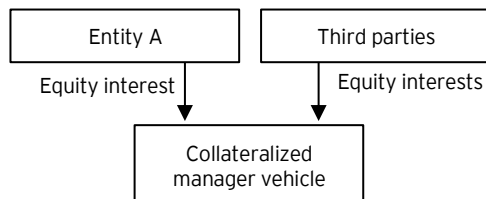
Illustration 7-20: VIE determination: evaluation of the rights held by the equity holders in a collateralized manager vehicle

This example is adapted from an SEC staff speech.³⁹

Entity A sponsors a collateralized manager vehicle (CMV), which is designed to sponsor securitization transactions. Entity A holds an equity interest in the CMV and one of three seats on the board. The remaining equity of the CMV is held by third parties, several of which are individually significant.

Entity A also provides certain support functions for the CMV, including middle- and back-office operations, investment research, and other administrative activities.

The equity holders of the CMV, as represented by the board of directors, have power over the most significant activities of the CMV, including the development of the investment strategy, the hiring and firing of service providers, and the appointment of individuals to the CMV's investment committee.



³⁹ Comments by Chris Rickli, SEC Professional Accounting Fellow, at the 2015 AICPA Conference on Current SEC and PCAOB Developments.

Analysis

The SEC staff did not object to the conclusion that the CMV was a voting interest entity. The analysis focused heavily on the ownership of the CMV and the role of the CMV's board of directors. The equity holders of the CMV, as represented by the board of directors, were deemed to have power over the most significant activities of the CMV.

The SEC staff emphasized that many variations of CMVs exist in the market, which may result in different accounting conclusions.

7.3.1.3.2**Limited partnerships and similar entities****Excerpt from Accounting Standards Codification****Consolidation – Overall****Glossary****810-10-20****Limited Partnership**

An association in which one or more general partners have unlimited liability and one or more partners have limited liability. A limited partnership is usually managed by the general partner or partners, subject to limitations, if any, imposed by the partnership agreement.

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 sections 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 (see section 2.3 for the definition of common control).

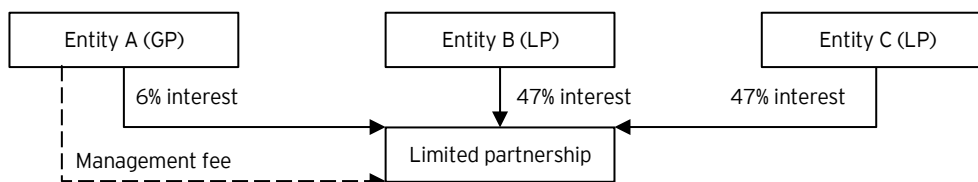
When evaluating whether the threshold for substantive participating rights has been met, a reporting entity should apply the guidance in the Voting Model at ASC 810-10-25-5. See section 11.3.2. This guidance requires that limited partners have the ability to participate in at least one significant operating or financial decision made in the ordinary course of business.

When determining whether 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.

The examples below illustrate the evaluation of kick-out rights. Refer to the table in section 7.3.1.3.3 for additional examples in the Codification on how to assess kick-out rights in limited partnerships and similar entities.

Illustration 7-21: 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.

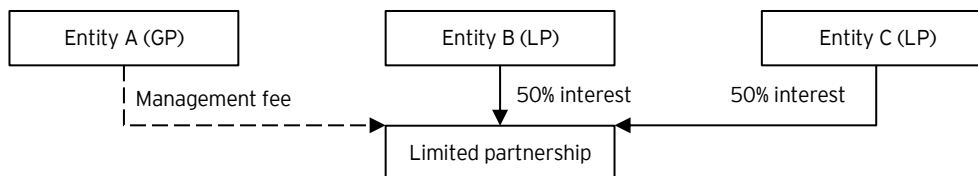


Analysis

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 7-22: VIE determination – simple majority of kick-out rights

The following example was adapted from ASC 810-10-55-4P and is similar to the example in ASC 810-10-55-4W. 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).



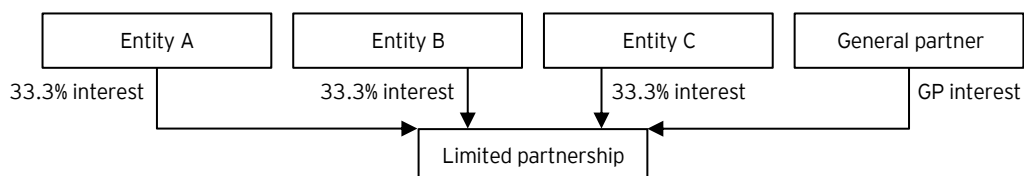
Analysis

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.

In addition, no partner would have a controlling financial interest in the limited partnership, because no single limited partner owns a majority of the limited partnership's kick-out rights through voting interests. Therefore, no partner consolidates the limited partnership. (See section 11.2.2 for guidance on determining which entity, if any, consolidates a limited partnership that is a voting interest entity).

Illustration 7-23: VIE determination – required voting percentages of more than a simple majority**Example 1**

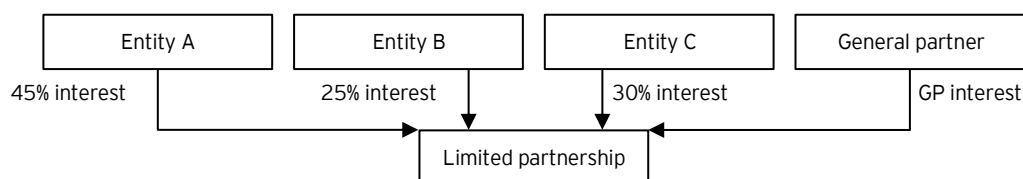
The following example was adapted from ASC 810-10-55-4S and is similar to the example in ASC 810-10-55-40. Entity A, Entity B and Entity C are three limited partners that each hold a 33.3% limited partnership interest. The limited partners are not related parties with the general partner. The limited partnership agreement requires a vote of 66.6% of the limited partnership interests to remove the general partner and the limited partners do not have substantive participating rights.

**Analysis**

A vote of two of the three limited partners represents 66.7% of the limited partnership interests, which is the smallest possible combination that is at least a simple majority of the limited partnership interests. Presuming the kick-out rights are substantive, the limited partners have the power through voting rights to direct the activities of the limited partnership that most significantly impact the partnership's economic performance. Therefore, the limited partnership would not be a VIE (assuming none of the other VIE criteria are met).

Example 2

The following example was adapted from ASC 810-10-55-4T. Assume the same facts in Example 1, except Entity A holds 45% of the limited partnership interests, Entity B holds 25% of them and Entity C holds 30% of them.

**Analysis**

To remove the general partner, a vote from Entity A in combination with either Entity B or Entity C would be a simple majority of the limited partnership interests and would satisfy the 66.6% contractual requirement. In contrast, a vote to exercise the kick-out right from Entity B and Entity C also would represent a simple majority of the limited partnership interests. However, their kick-out rights (55%) would not meet the required threshold of 66.6% to remove the general partner. Accordingly, the limited partners lack the power through voting rights to direct the activities of the limited partnership that most significantly impact its economic performance because the smallest possible combination (Entity B and Entity C) that represents at least a simple majority of the limited partnership interests cannot remove the general partner. Therefore, the limited partnership would be a VIE.

Example 3

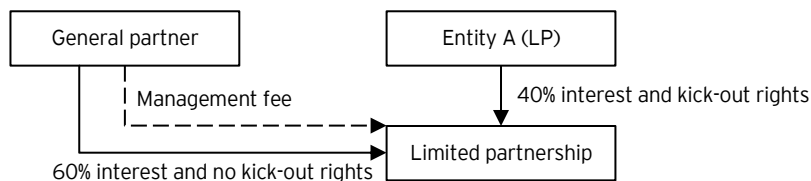
The following example was adapted from ASC 810-10-55-40 and is similar to the example in ASC 810-10-55-4U. Assume the same facts in Example 1, except all three limited partners must vote to remove the general partner.

Analysis

The limited partnership would be a VIE because more than a simple majority of the limited partners must vote to kick out the general partner.

Illustration 7-24: VIE determination – single limited partner

The following example was adapted from ASC 810-10-55-4V. Entity A is a limited partner that holds a 40% limited partnership interest, has kick-out rights and is not a related party to the general partner. The general partner owns 60% of the limited partnership interest and does not have kick-out rights.

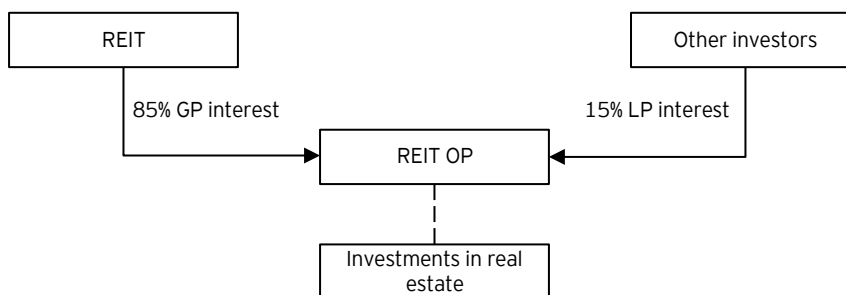
**Analysis**

The partnership is not 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.

Entity A has a controlling financial interest in the limited partnership, because it owns a majority of (in this case, all of) the limited partnership's kick-out rights through voting interests. Therefore, Entity A consolidates the limited partnership. (See section 11.2.2 for guidance on determining which entity, if any, consolidates a limited partnership that is a voting interest entity.)

Illustration 7-25: REIT operating partnership

A real estate investment trust (REIT) is the general partner of REIT Operating Partnership (OP) and holds 85% of the REIT OP's outstanding partnership units. The remaining 15% of limited partnership units held by other unrelated limited partners do not provide substantive kick-out or participating rights to these investors.

**Analysis**

The REIT OP is a VIE because the limited partnership units do not provide substantive kick-out or participating rights. Further, the REIT would be subject to the VIE disclosure requirements in ASC 810-10-50.

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 definitions of kick-out rights and liquidation 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.

The barriers listed in ASC 810-10-25-14A are not the only barriers that should be considered and are not determinative. A reporting entity should carefully evaluate the facts and circumstances of each arrangement.

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 4W for examples of how to assess kick-out rights and see section 4.2.7 for an example from the Codification involving a series fund.

ASC paragraph	Example
ASC 810-10-55-4N	Example 3: simple majority threshold for the application of kick-out rights
ASC 810-10-55-4O	Case A: three equal-interest limited partners (see also Example 1 in Illustration 7-23)
ASC 810-10-55-4P	Case B: two equal-interest limited partners (see also Illustration 7-22)
ASC 810-10-55-4Q	Case C: 100 equal-interest limited partners
ASC 810-10-55-4R	Case D: required limited partner voting percentages of more than a simple majority
ASC 810-10-55-4S	Case D1: equal-interest limited partners (see also Illustration 7-23)
ASC 810-10-55-4T	Case D2: limited partners with unequal interests (see also Example 2 in Illustration 7-23)
ASC 810-10-55-4U	Case E: four equal-interest limited partners with a required unanimous vote of the limited partnership's kick-out rights through voting interests
ASC 810-10-55-4V	Case F: limited partner and general partner with a required simple majority percentage of the limited partnership's kick-out rights through voting interests – limited partner consolidates
ASC 810-10-55-4W	Case G: four equal-interest limited partners with a required simple majority percentage of the limited partnership's kick-out rights through voting interests – no partner consolidates (see also Illustration 7-22)

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 of 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).

7.3.1.3.4 **Participating rights**

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 a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A **decision maker** also shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 810-10-55-37 through 55-38...

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.

Only substantive participating rights are considered in the evaluation of whether an entity is a VIE, consistent with the guidance discussed in section 3. ASC 810 provides guidance on how to evaluate whether participating rights are substantive, which is discussed in section 11.3.2.1.1. ASC 810 also provides guidance on evaluating whether barriers prevent a kick-out right from being substantive, discussed in section 7.3.1.3.3, which also may be relevant when assessing the substance of participating rights. When evaluating whether a participating right is substantive, all facts and circumstances should be considered, except the likelihood that the holder of a participating right will exercise that right, which should not be considered.

As discussed in section 7.3.1.3.1, for corporations and similar entities, when a single party (including its related parties and de facto agents) other than the at-risk equity holders has the unilateral right to participate in or block decisions of the at-risk equity holders that significantly impact the economics of the entity, the entity is a VIE. However, if unrelated parties that are not at-risk equity holders have the ability to exercise participating rights as a group, the at-risk equity holders do not lack the power to direct the activities of a legal entity that most significantly impact the entity's economic performance; that is, the entity would not be a VIE due to this characteristic.

For partnerships and similar entities, see section 7.3.1.3.2 for a discussion of how participating rights affect the determination of whether the entity is a VIE.

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 causing the entity to be a VIE. However, careful evaluation is required to distinguish a participating right from a protective right, based on the purpose and design of the entity.

Illustration 7-26: 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.

If Entities B and C had to collectively agree to block Entity A's approval of the budget, the corporation would not be a VIE under this characteristic (that is, Entity A is not prevented from having the power to make decisions about the corporation that significantly affect its economics). However, the other characteristics of a VIE would still need to be evaluated before reaching a conclusion.

7.3.1.3.5

Protective rights**Excerpt from Accounting Standards Codification****Consolidation – Overall****Implementation guidance and illustrations****810-10-55-1**

Examples of how to assess individual noncontrolling rights facilitate the understanding of how to assess whether the rights of the noncontrolling shareholder or limited partner should be considered protective or participating and, if participating, whether the rights are substantive. An assessment is relevant for determining whether noncontrolling rights overcome the presumption of control by the majority shareholder or limited partner with a majority of **kick-out rights** through voting interests in an entity under the General Subsections of this Subtopic. Although the following examples illustrate the assessment of **participating rights** or **protective rights**, the evaluation should consider all of the factors identified in paragraph 810-10-25-13 to determine whether the noncontrolling rights, individually or in the aggregate, provide for the holders of those rights to effectively participate in certain significant financial and operating decisions that are made in the **ordinary course of business**:

- a. The rights of the noncontrolling shareholder or limited partner relating to the approval of acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business may be substantive participating rights. Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of the investee's existing business usually are protective and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. Whether a right to approve the acquisition or disposition of assets is in the ordinary course of business should be based on an evaluation of the relevant facts and circumstances. In addition, if approval by the shareholder or limited partner is necessary to incur additional indebtedness to finance an acquisition that is not in the investee's ordinary course of business, then the approval by the noncontrolling shareholder or limited partner would be considered a protective right.
- b. Existing facts and circumstances should be considered in assessing whether the rights of the noncontrolling shareholder or limited partner relating to an investee's incurring additional indebtedness are protective or participating rights. For example, if it is reasonably possible or probable that the investee will need to incur the level of borrowings that requires noncontrolling shareholder or limited partner approval in its ordinary course of business, the rights of the noncontrolling shareholder or limited partner would be viewed as substantive participating rights.
- c. The rights of the noncontrolling shareholder or limited partner relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions would be protective rights.
- d. The rights of the noncontrolling shareholder or limited partner relating to an investee's specific action (for example, to lease property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if the investee had the ability to purchase, rather than lease, the property without requiring approval of the noncontrolling shareholder or limited partner, then the rights of the noncontrolling shareholder or limited partner to block the investee from entering into a lease would not be substantive.

- e. The rights of the noncontrolling shareholder or limited partner relating to an investee's negotiation of collective bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if an investee does not have a collective bargaining agreement with a union or if the union does not represent a substantial portion of the investee's work force, then the rights of the noncontrolling shareholder or limited partner to approve or veto a new or broader collective bargaining agreement are not substantive.
- f. Provisions that govern what will occur if the noncontrolling shareholder or limited partner blocks the action of an **owner** of a majority voting interest or general partner need to be considered to determine whether the right of the noncontrolling shareholder or limited partner to block the action has substance. For example, if the shareholder or partnership agreement provides that if the noncontrolling shareholder or limited partner blocks the approval of an operating budget, then the budget simply defaults to last year's budget adjusted for inflation, and if the investee is a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights of the noncontrolling shareholder or limited partner to block the approval of the operating budget do not allow the noncontrolling shareholder or limited partner to effectively participate and are not substantive.
- g. Noncontrolling rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances. For example, if lawsuits are a part of the entity's ordinary course of business, as is the case for some patent-holding companies and other entities, then the noncontrolling rights may be considered substantive participating rights.
- h. A noncontrolling shareholder or limited partner has the right to veto the annual operating budget for the first X years of the relationship. Based on the facts and circumstances, during the first X years of the relationship this right may be a substantive participating right. However, following Year X there is a significant change in the exercisability of the noncontrolling right (for example, the veto right terminates). As of the beginning of the period following Year X, that right would no longer be a substantive participating right and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee.

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 11.3.2.2 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)(01) 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.⁴⁰

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 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 7-27: 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.

⁴⁰ See paragraph A64 of FAS 167.

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

Holders of the residual equity interests 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).⁴¹

7.3.1.6

Limited liability companies (updated August 2022)

Excerpt from Accounting Standards Codification

Limited Liability Entities – Overall

Overview and Background

272-10-05-2

A limited liability company generally has the following characteristics:

- a. It is an unincorporated association of two or more persons.
- b. Its members have limited personal liability for the obligations or debts of the entity.
- c. It is classified as a partnership for federal income tax purposes.

272-10-05-3

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.

⁴¹ See paragraph A65 of FAS 167.

272-10-05-4

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.

Consolidation – Overall**Overview and Background****810-10-05-3**

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.

Limited liability companies (LLCs) have some characteristics of both corporations and partnerships. Illustration 7-28 compares the characteristics of many LLC structures to corporations and partnerships. These characteristics may not be present in all LLC structures.

Illustration 7-28: Similarities and differences between LLCs, corporations and partnerships			
Characteristic of an LLC	Similar to corporations	Similar to partnerships	Unique to LLCs
Members of an LLC (i.e., its owners) generally are not personally liable for the LLC’s liabilities.	X		
Members of an LLC – rather than the entity itself – are taxed on their respective shares of the LLC’s earnings.		X	
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.			X
Financial interests in most LLCs may be assigned only with the consent of all of the LLC members.		X	
LLCs generally are dissolved by death, bankruptcy or withdrawal of a member.		X	

To determine whether an LLC should be considered a partnership or a corporation when evaluating whether the equity holders as a group have power, a reporting entity should focus on how the members of the LLC govern the LLC and whether they are analogous to limited partners. For example, a reporting entity should consider whether the responsibilities of the LLC's managing member 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) or the role of the board of directors (if one exists). Judgment may be required to determine whether an LLC should be evaluated as a corporation or as a partnership, depending on the facts and circumstances.

7.3.2

Obligation to absorb an entity's expected losses

Excerpt from Accounting Standards Codification

Consolidation – Overall

Scope and Scope Exceptions – Variable Interest Entities

810-10-15-14(b)

- b. As a group the holders of the equity investment at risk lack any one of the following three characteristics ...
2. The obligation to absorb the **expected losses** of the legal entity. The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the legal entity itself or by other parties involved with the legal entity. See paragraphs 810-10-25-55 through 25-56 and Example 1 (see paragraph 810-10-55-42) for a discussion of expected losses ...

If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE.

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 (ASC 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 7-29: 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 7-30: 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. As a result, the entity would not be a VIE.

Residual value guarantees also may cause an entity to be a VIE.

Illustration 7-31: 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 7-32: 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 SOFR-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 7-33: 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 disproportionate allocation of the entity's cash flows among the holders of variable interests 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.

See section 5.4 for additional examples of common arrangements that may protect equity investments at risk from absorbing losses.

Question 7.14

Entities commonly enter into normal and customary business arrangements (e.g., property and casualty insurance, hedging arrangements) or include standard representations and warranties in contracts to protect equity holders from the risk of loss. Do these arrangements or contractual terms 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 property and casualty insurance, business interruption insurance or an indemnity in a business acquisition, protect the equity holders from risk of loss, we do not believe they result in the entity, by design, being a VIE. Similarly, we believe that providing standard representations and warranties generally would not result in the entity being a VIE. Standard representations and warranties usually relate to discrete events that occurred before the reporting entity's involvement with the entity and to events that are clearly separable from the entity's ongoing operations.⁴²

However, if the arrangement or contractual term protects the equity at risk holders from a risk that the entity was designed to create and pass through to its variable interest holders (i.e., the representation is not standard), the entity would be 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 7-34: 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.

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.

⁴² In the context of ASC 860, standard representations and warranties are defined in the ASC Master Glossary as "representations and warranties that assert the financial asset being transferred is what it is purported to be at the transfer date." Examples include representations and warranties about (1) the characteristics, nature and quality of the underlying financial asset, including characteristics of the underlying borrower and the type and nature of the collateral securing the underlying financial asset; (2) the quality, accuracy and delivery of documentation relating to the transfer and the underlying financial asset; and (3) the accuracy of the transferor's representations in relation to the underlying financial asset.

Illustration 7-35: 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 7-36: 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 section 6 for guidance on identifying silos).

Illustration 7-37: 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 7-38: 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

Excerpt from Accounting Standards Codification**Consolidation – Overall****Scope and Scope Exceptions – Variable Interest Entities****810-10-15-14(b)**

b. As a group the holders of the equity investment at risk lack any one of the following three characteristics ...

3. The right to receive the **expected residual returns** of the legal entity. The investors do not have that right if their return is capped by the legal entity's governing documents or arrangements with other variable interest holders or the legal entity. For this purpose, the return to equity investors is not considered to be capped by the existence of outstanding stock options, convertible debt, or similar interests because if the options in those instruments are exercised, the holders will become additional equity investors ...

If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE.

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**

The Variable Interest Model requires the equity holders, as a group, to have the right to receive the entity's expected residual returns (ASC 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 7-39: 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 7-40: Call option to acquire 100% of entity's outstanding stock

Assume the same facts as Illustration 7-39, 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 7-39 and 7-40 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 7-41: Call option to acquire a percentage of entity's assets

Assume the same facts as Illustration 7-39, 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 7-42: 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 7-43: 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 7-44: 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 ASC 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 section 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 section 6 for guidance on identifying silos).

Illustration 7-45: 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 7-46: 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 7-47: 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 7-48: 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

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).

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 7-49: 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: Votes are disproportionate 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.
 - ▶ 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 either 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.

Illustration 7-50: Determining whether voting rights are proportionate to economic rights

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.

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 (e.g., debt) held by an investor be considered?

ASC 810-10-15-14(c) requires 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 7-51: 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**

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 entity, their right to receive the expected residual returns or both.
 - ▶ 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 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 investor⁴³ with disproportionately few voting rights include:

- ▶ Are the entity's operations substantially similar in nature to the activities of the investor with disproportionately few voting rights?
- ▶ Are the entity's operations more important to the investor with disproportionately few voting rights than the other variable interest holders?
- ▶ What decisions does the investor with disproportionately few voting rights participate in and to what extent?
- ▶ Are the majority of the entity's products or services bought from or sold to the investor with disproportionately few voting rights?
- ▶ 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?

⁴³ 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.

- ▶ 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 7-52: 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, a reporting entity considers whether an individual investor 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, an investor treats 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 7-53: 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

Condition 1

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.

Condition 2

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 (Oilco’s related party) operations. As a crude oil refiner, Refineco commonly acquires chemical feedstocks for use in its refining operations and sales of chemical feedstocks to Refineco will constitute approximately two-thirds of the LLC’s revenues. Therefore, after considering the qualitative and quantitative factors, it is determined that the activities of the LLC are deemed to be substantially on behalf of the related party group (including Refineco) of the investor (Oilco) with disproportionately few voting rights.

Conclusion

Since both Condition 1 and Condition 2 are met, 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 810-10-25-43.⁴⁴

⁴⁴ See paragraph D23 of FIN 46(R).

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 section 10).

Illustration 7-54: 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.

7.4.4

Illustrative examples

Illustration 7-55: Anti-abuse test**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 its purpose and design and future changes that are required by existing governing documents or contractual arrangements that have a substantive effect on the consolidation analysis.

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.

See section 8.2.3.6.1 for guidance for evaluating whether the equity-at-risk holders have power when the decision making over the significant activities of an entity shifts during its life cycle based on its purpose and design at inception. In addition, see Question 8.2 for guidance on evaluating power when there appears to be no substantive decision making about the activities of an entity (sometimes referred to as entities on auto-pilot). These concepts also are relevant when evaluating whether the equity-at-risk holders lack the power over the activities that significantly affect the entity's economics (the second characteristic of a VIE).

As discussed in section 12, the Variable Interest Model requires a reporting entity to reevaluate whether an entity is a VIE upon the occurrence of certain significant events.

Illustration 7-56: 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 section 12 for reconsideration events).

Illustration 7-57: 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 section 12 for reconsideration events).

8 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. Only one party can be identified as the primary beneficiary.

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 section 11 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.

If a reporting entity concludes that no party 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 must consider the Variable Interest Model’s related party provisions to determine if one of the related parties is the primary beneficiary. See section 9 for additional guidance.

The Variable Interest Model requires a reporting entity to continuously assess whether it is the primary beneficiary of a VIE (see section 12.2 for additional guidance).

If, after considering the guidance in ASC 810-10, including the Variable Interest Model, a reporting entity determines that it is not required to consolidate a research and development (R&D) arrangement in which the sponsor of the R&D arrangement provides all of the funds for the R&D program, it should apply ASC 810-30 to these arrangements.⁴⁵ Accordingly, we believe it will be relatively rare that entities apply ASC 810-30. See section R7.2.7, ***Consolidation considerations for R&D arrangements in which all funds are provided by a sponsor***, of our Accounting Manual for more guidance.

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?

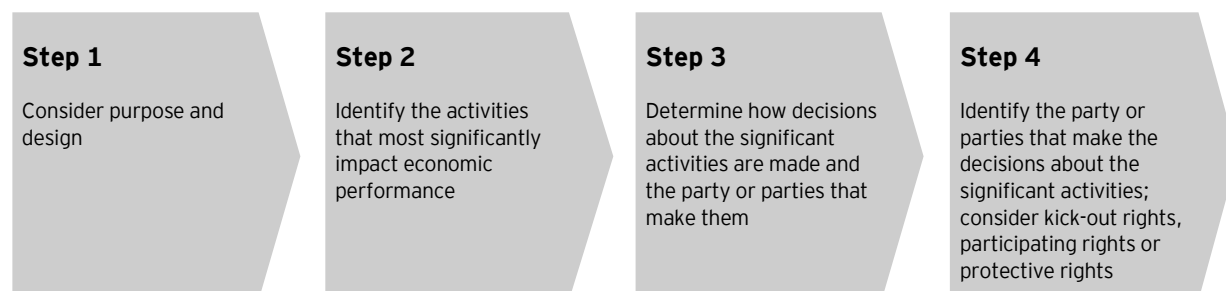
No. Some mistakenly focus on economics when trying to determine whether a reporting entity is the primary beneficiary of a VIE. Under FIN 46(R), the primary beneficiary test was quantitative. A reporting entity would consolidate a VIE if it had a variable interest (or combination of variable interests) 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.⁴⁶ An evaluation under this approach requires the use of significant judgment.

⁴⁵ ASC 810-30-15-3(b)

⁴⁶ See page iii of the overview to FAS 167.

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 section 5.2 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.

See Question 8.2 for how to consider involvement in the design of an entity for VIEs that appear to be on "auto-pilot."

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, considering the risks that the entity was designed to create and pass through to its variable interest holders. 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. The significant activities identified will differ by the type, industry and operations of entity being evaluated and require significant judgment, based on the facts and circumstances. Examples of significant activities may include:

- ▶ Purchasing or selling significant assets
- ▶ Entering new lines of business or expanding the entity's goods or services
- ▶ Incurring additional indebtedness or issuing significant equity interests
- ▶ Approving operating and capital budgets
- ▶ Hiring, firing and compensating management
- ▶ Making acquisition and/or divestiture decisions
- ▶ Determining the strategic operating direction of the entity
- ▶ Establishing a marketing and sales strategy

Activities that are solely administrative in nature (e.g., accounting) are not significant activities, because they do not significantly impact the VIE's economic performance.

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. The SEC staff also has stated that for entities that have only a limited range of activities, the evaluation of power requires an analysis of both the decisions made at inception of the entity and decisions made about any ongoing activities.⁴⁷

For entities with limited decision making, the following considerations may be relevant:

- ▶ The ability of the holders of the equity investment at risk, as a group or individually, to change governing documents or other contractual arrangements that were established at the VIE's inception may give those parties power if the arrangements govern the activities that significantly impact the VIE's economic performance.
- ▶ 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, as discussed in section 8.2.1.1.
- ▶ 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, as discussed in section 8.3.2.

⁴⁷ Comments by Wesley R. Bricker, SEC Professional Accounting Fellow, at the 2010 AICPA National Conference on Current SEC and PCAOB Developments.

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: Determine 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 determine 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.

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 determine which party has the power over the activities that are most significant (see section 8.2.3.6).

In the following illustrations, we summarize some of examples in ASC 810 that explain how to determine which activities most significantly impact a VIE's economic performance and the party or parties that make the decisions about those activities.

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

The following example is adapted from ASC 810-10-55-78 through 80. 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 financing 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 investment in the VIE 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 VIE 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.

Illustration 8-4: Power – asset manager

The following example is adapted from an SEC staff speech.⁴⁸ A limited partner forms a limited partnership with an unrelated party, the general partner. Both parties have variable interests in the limited partnership.

The limited partnership is a VIE. Its primary purpose is to manage assets pursuant to broad investment guidelines. The limited partner was significantly involved in establishing investment guidelines. The general partner makes investment decisions subject to the investment guidelines. The limited partner can modify certain aspects of the guidelines but does not have the ability to significantly limit the general partner's discretion over investment decisions.

Analysis

Because the guidelines were designed to provide the general partner with significant discretion to make investment decisions, which is the activity that most significantly impacts the VIE's economic performance, the general partner has power over the VIE.

⁴⁸ Comments by Aaron Shaw, SEC Professional Accounting Fellow, at the 2019 AICPA National Conference on Current SEC and PCAOB Developments.

Illustration 8-5: Power – single-asset entity

The following example is adapted from an SEC staff speech.⁴⁹ Entity A leases an asset from a single-asset LLC that is a VIE. The purpose of the VIE is to lease its single property to Entity A for substantially all of the property's economic life and to provide a return to its investors through the lease payments and sale of the property at the end of the lease.

Under the terms of the lease, Entity A is obligated to operate and maintain the property (including any significant structural maintenance) and makes related decisions about those activities. The VIE has the right to sell the property at the end of the lease.

The following risks were evaluated to determine whether they were creators of variability in the VIE, based on its purpose and design:

Risk	Evaluation
Lease negotiation	Not significant, because the lease term covered substantially all of the property's economic life
Credit risk	Not significant, because Entity A's financial condition and the property's strategic importance to Entity A mitigated credit risk
Residual value	Significant
Operation and maintenance	Significant

Analysis

The activities related to residual value risk and operation and maintenance risk were determined to be the VIE's most significant activities. Operation and maintenance decisions made by Entity A during the lease term were determined to have the most significant impact on the VIE's economic performance, as those decisions affect both operation and maintenance risk as well as the residual value of the property at the end of the lease. Therefore, Entity A has power over the single-asset LLC.

Refer to ASC 810-10-55-93 through 205 for additional examples of identifying the primary beneficiary.

ASC paragraph	Example
ASC 810-10-55-93 through 95	Background information that applies to all examples below
ASC 810-10-55-96 through 109	Case A: commercial mortgage-backed securitization
ASC 810-10-55-110 through 121	Case B: asset-backed collateralized debt obligation
ASC 810-10-55-122 through 133	Case C: structured investment vehicle
ASC 810-10-55-134 through 146	Case D: commercial paper conduit
ASC 810-10-55-147 through 159	Case E: guaranteed mortgage-backed securitization
ASC 810-10-55-160 through 171	Case F: residential mortgage-backed securitization
ASC 810-10-55-172 through 181	Case G: lessor VIE (direct financing lease) with single lessee (operating lease)

⁴⁹ Comments by Aaron Shaw, SEC Professional Accounting Fellow, at the 2019 AICPA National Conference on Current SEC and PCAOB Developments.

ASC paragraph	Example
ASC 810-10-55-182 through 198	Case H: collaboration – joint venture arrangement
ASC 810-10-55-199 through 205	Case I: furniture manufacturing entity
ASC 810-10-55-205L through 205V	Case J: investment fund 1 – annual and performance-based fees and additional interests
ASC 810-10-55-205W through 205Y	Case K: investment fund 2 – annual and performance-based fees and no additional interests
ASC 810-10-55-205Z through 205AI	Case L: e-commerce entity

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 section 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 section 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. See section 9 for guidance on determining the primary beneficiary in a related party group and section 10 for guidance on identifying related parties, including de facto agents.

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.⁵⁰ However, when a VIE, by design, requires all variable interest holders to approve decisions about the significant activities, the SEC staff has not objected to the conclusion that power is shared.⁵¹ Section 9.3 includes an illustration in which certain decisions require unanimous consent, but one party can unilaterally make other decisions; therefore, power is not shared.

Refer to ASC 810-10-55-184 through 192 for an additional example of shared power.

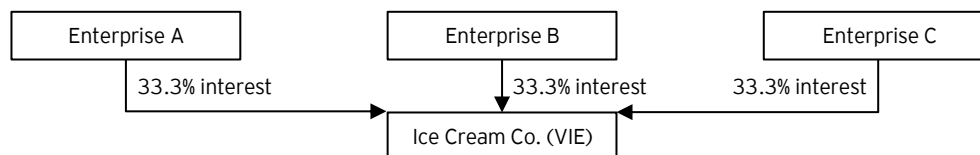
Illustration 8-6: Shared power**Example 1**

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 33.3% 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.

⁵⁰ Comments by Christopher F. Rogers, SEC Professional Accounting Fellow, and Wesley R. Bricker, SEC Professional Accounting Fellow, at the 2014 and 2010 AICPA National Conference on Current SEC and PCAOB Developments, respectively, and by Paul A. Beswick, Deputy Chief Accountant, at the 29th Annual SEC and Financial Reporting Institute Conference.

⁵¹ Comments by Damon Romano, SEC Professional Accounting Fellow, at the 2020 AICPA Conference on Current SEC and PCAOB Developments.

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 about 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, none of the parties consolidate 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 section 9.3).

Example 2

The following example was adapted from an SEC staff speech.⁵²

Enterprise D and Enterprise E are unrelated parties that are the only variable interest holders in a VIE. At the date of Enterprise D's investment in the VIE, the VIE was winding down its activities due to the termination of its only contract. Therefore, on the date of the evaluation, the purpose and design of the VIE was to perform under the remaining term of the existing contract.

Enterprise D determined that the activities that significantly impact the VIE's economic performance are (1) approving the annual budget; (2) approving suppliers to fulfill the contract, and (3) appointing, removing or replacing the CEO. Decisions about these activities require a majority vote of the VIE's board of directors and approval from both Enterprise D and Enterprise E.

Analysis

The VIE 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 VIE. Since all decisions regarding the significant activities of the VIE require the approval of Enterprise D and Enterprise E in addition to a majority of the board of directors, no party can independently make decisions about the VIE's significant activities. Therefore, neither Enterprise D nor Enterprise E consolidate the VIE.

⁵² Comments by Damon Romano, SEC Professional Accounting Fellow, at the 2020 AICPA Conference on Current SEC and PCAOB Developments.

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 8-7: Power conveyed through a board of directors and no one party controls the board

Example 1

Assume the same facts as in Illustration 8-6, 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 8-6. 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.

The following example is adapted from ASC 810-10-55-194 through 196.

Illustration 8-8: 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.

However, if one of the parties has the ability to make decisions unilaterally about an activity (or activities) that most significantly impacts the VIE's economic performance and has benefits, but decisions about other activities require agreement by multiple parties, the party that can make decisions unilaterally is the primary beneficiary (even if the significant activities for which power is shared more significantly impact the economic performance of the entity than the significant activities that are directed unilaterally). The SEC staff has emphasized this point.⁵³ See section 8.2.3.6.2 for additional discussion.

⁵³ Comments by Christopher F. Rogers, SEC Professional Accounting Fellow, at the 2014 AICPA National Conference on Current SEC and PCAOB Developments.

The following example is adapted from ASC 810-10-55-193 and illustrates a situation when multiple unrelated parties unilaterally direct different significant activities of a VIE.

Illustration 8-9: 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:

Significant activity

Manufacturing
Distributing
Selling

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:

Significant activity

Manufacturing
Distributing
Selling

Responsible party

Manufacture Co.
Distribute Co.
Distribute Co.

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.

An additional example in which multiple unrelated parties direct different activities is in ASC 810-10-55-197 through 198.

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 8-10: 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.

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 entity

Some entities have a governance structure that includes a board of directors appointed by the equity holders and an operations manager who performs certain day-to-day functions. In these circumstances, it may be challenging to determine whether the equity holders as a group have power (which they exert through their representation on the board of directors) or whether the operations manager has power when it holds a variable interest in the entity. If the operations manager does not have a variable interest in the entity, it cannot have power. See section 5.4.13 for guidance on determining whether an operation manager's fees are a variable interest.

As discussed in section 8.2.1, it is important to first identify the activities that most significantly impact the economic performance of the entity and how decisions about those activities are made, which requires judgment. For example, this may include determining whether the equity holders as a group have power (through their participation on the board of directors) over decisions through the budget process or whether the operations manager has power over decisions (through day-to-day management). 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, the operations manager may not have power. 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 the operations manager does not have power. 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 operations manager does not have power if the budgetary protocols require 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 the activities of the operations manager are constrained by the budget process.

If the board of directors has significant involvement in preparing and reviewing the budget, it may be more likely that power rests with the equity holders as a group through their representation on 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. 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.

Illustration 8-11: Board of directors and operations manager, where operations manager is constrained by the board

Facts

A VIE is formed by two unrelated equity investors to distribute a product to an unrelated third party. Each equity investor has one seat on the VIE's board of directors, and all board decisions require a unanimous vote of the two board members (i.e., neither investor controls the board of directors). The two investors jointly decide to hire an unrelated third party with distribution management experience (the operations manager) to manage the day-to-day operations of the VIE.

The operations manager has a variable interest in the VIE 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 considering the VIE's purpose and design, assume there are three activities that most significantly impact the entity's economic performance: (1) financing decisions, (2) capital decisions and (3) operating decisions.

The board of directors makes all financing and capital decisions and approves the operating budget. The operations manager makes day-to-day decisions on how to implement the operating budget and has certain latitude on decisions, including product procurement, product pricing, contract negotiation and hiring/firing employees. However, considering the nature and extent of the board's involvement in the budget process, the operations manager does not have power over the operating decisions of the VIE.

Analysis

Since the equity holders as a group (through their representation on the board) have power over the operating decisions, neither equity investor would have a controlling financial interest in the VIE. This is because all three decisions about the activities that most significantly impact the VIE's economic performance (i.e., financing, capital and operating decisions) are made through the board of directors, and neither investor controls the board. In addition, since the decision making of the operations manager is sufficiently constrained by the board, the operations manager also does not have a controlling financial interest in the VIE and there would be no primary beneficiary.

The SEC staff has indicated that when power over some of the VIE's significant activities is shared, but other significant activities are unilaterally directed by one of the parties, that one party will have power (even if the significant activities for which power is shared more significantly impact the economic performance of the entity than the significant activities that are directed unilaterally).⁵⁴ Furthermore, ASC 810-10-25-38E states, "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." Therefore, we believe that when one party (e.g., the operations manager) is the only party with power to direct one of the activities of the entity that most significantly impact the economic performance, that party has the power, even if it does not share power over the other significant activities. As discussed in section 8.2.3.4, the board of directors is not considered a single party, but rather a mechanism for the equity holders to exert power.

Illustration 8-12: Board of directors and operations manager where operations manager has power over one significant activity

Facts

Assume the same facts as Illustration 8-11; however, the operations manager alone has power over the operating decisions (i.e., the board does not constrain the operations manager's decisions about the operating activities).

Analysis

Since the operations manager alone has power over operating decisions (i.e., the board's involvement does not constrain the operations manager), the operations manager is the primary beneficiary and consolidates the VIE. This is because the operations manager has the power to direct one of the significant activities (i.e., operating decisions), while no one party has the ability to direct the other two significant activities (i.e., financing and capital decisions). The population of activities that is evaluated for this purpose is the same set of activities that is identified considering the VIE's purpose and design (as discussed in sections 8.2.1 and 8.2.2) and most significantly impact the economic performance of the entity.

⁵⁴ Comments by Christopher F. Rogers, SEC Professional Accounting Fellow, at the 2014 AICPA National Conference on Current SEC and PCAOB Developments.

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 VIE 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

See section 2.8 and Question 7.11 for more guidance on evaluating whether redemption rights and liquidation rights are similar to kick-out rights.

Illustration 8-13: 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 (i.e., there are no significant barriers to exercise).

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 8-14: 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 section 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.

Refer to ASC 810-10-55-199 through 205 for an example of identifying the primary beneficiary when one party has protective rights.

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

Excerpt from Accounting Standards Codification

Consolidation – Overall

Recognition – Variable Interest Entities

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...

- 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...

In addition to having power, the primary beneficiary of a VIE must have what is known as “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 future benefits. If a reporting entity has a variable interest, it often has benefits.

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 all possible outcomes over the life of the entity, and the analysis generally should not consider the likelihood of the outcome.⁵⁵ This assessment should be made in the context of the purpose and design of the VIE, the risks that the VIE was designed to create, and the variability that the variable interests were designed to absorb. A reporting entity has “benefits” if it *could* absorb significant losses or returns, even if the possibility of events that could lead to such losses or returns is remote. However, the more remote the scenario is, the less likely it is that the risk being absorbed is a part of the purpose and design of the entity.

The Variable Interest Model refers to negative variability as “expected losses” and positive variability as “expected residual returns.” As a reminder, expected losses are not the same as net losses expected to be incurred by the VIE, and expected residual returns are not the same as net income expected to be earned by the VIE. Instead, expected losses and expected residual returns are derived using projected cash flow techniques and are measures of the variability (or risk) inherent in the fair value of a VIE. Because expected losses and expected residual returns represent the potential variability from the expected cash flows of an entity, all VIEs with the potential for multiple possible outcomes have expected losses. Even VIEs that were profitable and expect to be profitable in the future have expected losses. See section D.2 for more guidance on expected losses and residual returns.

We believe a reporting entity generally has benefits if its variable interests, individually or in the aggregate, *could* expose it to losses or returns potentially exceeding 10% of the expected losses or returns of the VIE. However, the FASB did not provide guidance on determining whether a reporting entity has benefits⁵⁶; therefore, 10% should not be viewed as a bright line. That is, a reporting entity may conclude that it has benefits even if its exposure to expected losses or returns is less than 10%.

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 returns, which is different from the evaluation of whether the equity is at risk (as discussed in section 7.2.2.1). 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 if it is not entitled to receive any returns. Similarly, if a reporting entity has power and has the right to receive returns that could be significant but has no obligation to absorb losses, it is the primary beneficiary.

⁵⁵ Arie S. Wilgenburg, SEC Professional Accounting Fellow, at the 2009 AICPA National Conference on Current SEC and PCAOB Developments stated “A second factor may be the terms and characteristics of your financial interest. While the probability of certain events occurring would generally not factor into an analysis of whether a financial interest could potentially be significant, the terms and characteristics of the financial interest (including the level of seniority of the interest), would be a factor to consider.”

⁵⁶ Paragraph BC A41 of FAS 167 and paragraph BC56 of ASU 2015-02.

The use of professional judgment will be required when evaluating whether a reporting entity has benefits. Such judgments generally are qualitative, although a quantitative analysis might be informative in some cases.⁵⁷ A reporting entity should consider all facts and circumstances, including⁵⁸:

- ▶ The terms and characteristics of the variable interest(s), including any disproportionality, caps or limits, and the capital structure of the VIE (see Question 8.8), and how those *could* affect the variability that the variable interests *could* absorb
- ▶ The purpose and design of the VIE and the variable interests (as discussed in section 5.2)
- ▶ The other involvements of the reporting entity with the VIE and the reasons for holding the interests (e.g., reputation, which may indicate that the reporting entity is exposed to losses)

These judgments should be consistent for similar arrangements. The reporting entity is not required to use a quantitative analysis, and a quantitative analysis should not be the sole determinant, in contrast to the approach that was required under FIN 46(R).

Question 8.8

If a VIE has multiple tranches in its capital structure, how should a reporting entity determine whether its interests meet the benefits criterion?

If a VIE has multiple tranches of capital (i.e., multiple classes of debt or equity), the evaluation of whether a reporting entity's interests in the VIE meet the benefits criterion should consider the level of subordination of those interests within the capital structure.

While interests in a more subordinated tranche of the capital structure typically absorb more variability than interests in a more senior tranche, all tranches should be evaluated. For example, if a reporting entity has an overall interest in a collateralized loan obligation (CLO) equal to 5% of the fair value of **all** asset-backed interests issued as part of the securitization and that interest resides **entirely** in the most subordinated tranche of equity (i.e., a horizontal slice, as shown in the illustration below), the reporting entity likely is exposed to losses or returns that potentially could be significant to the VIE, because the reporting entity would likely hold a significant portion of the equity that is designed to absorb the first dollar risk of loss.

In contrast, if a reporting entity has a 5% interest in **each** of the tranches (i.e., a vertical slice, as shown in the illustration below), the reporting entity may not be exposed to losses or returns that potentially could be significant to the VIE, because it would absorb only a small portion of the expected losses through holding 5% of each tranche.

Facts and circumstances should be carefully evaluated when determining whether a reporting entity's interests in a VIE with multiple tranches within its capital structure meet the benefits criterion (i.e., both senior and subordinated tranches). If a reporting interest has an L-shaped interest (i.e., a combination of a vertical slice and a horizontal slice, as shown in the illustration below), additional judgment will be required based on facts and circumstances. Similar considerations apply if a VIE distributes profits and losses to its equity holders on a basis other than pro rata, or if the VIE has multiple classes of stock.

⁵⁷ Paragraph BC A43 of FAS 167 and comments by Paul A. Beswick, Deputy Chief Accountant, at the 2010 AICPA National Conference on Current SEC and PCAOB Developments, where he stated that "questions about whether a party's rights or obligations are significant to the entity are best resolved through a qualitative framework that weighs the particular facts and circumstances of the party's rights and obligations."

⁵⁸ Comments by Arie S. Wilgenburg, SEC Professional Accounting Fellow, at the 2009 AICPA National Conference on Current SEC and PCAOB Developments.

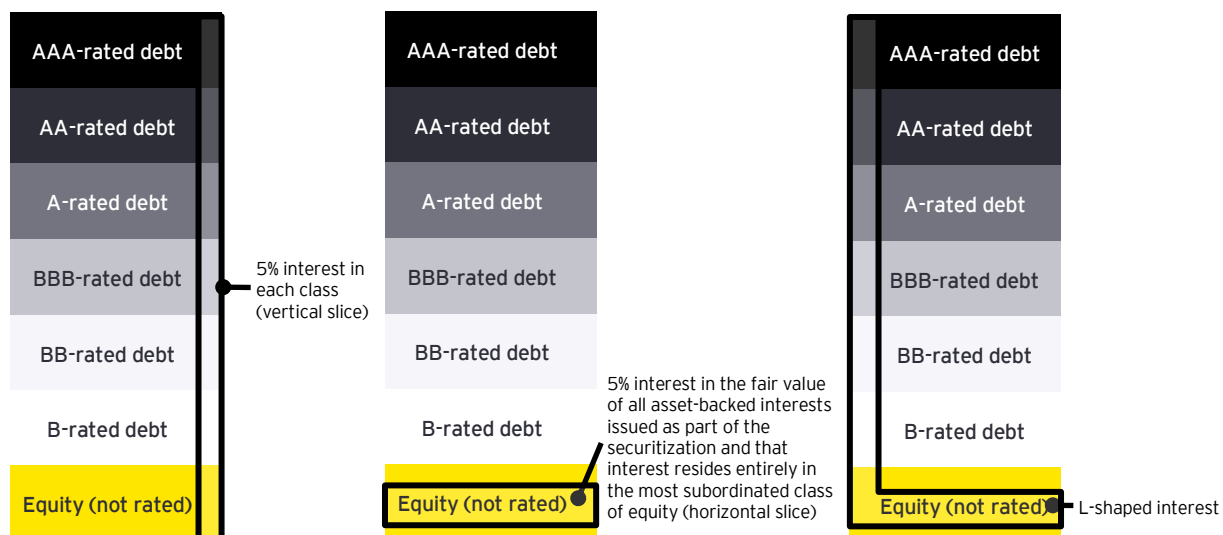


Illustration 8-15: Interests in tranches of a VIE's capital structure

A VIE is created in which \$80 million (80%) of the total capital is held in senior investment-grade notes while the remaining \$20 million (20%) of the capital is held in subordinated notes. Of the total capital, Party A holds \$9 million (9%, or \$9 million / \$100 million), but that interest is held only in subordinated notes (i.e., a horizontal slice). Third parties hold the remaining interests in the VIE. The following table illustrates the capital structure of the VIE:

	Party A	Third parties	Total
Senior investment-grade notes	-	\$80 million	\$80 million
Subordinated notes	\$9 million	\$11 million	\$20 million
Total	\$9 million	\$91 million	\$100 million

Analysis

Party A is exposed to returns that potentially could be significant even though it holds only 9% of the VIE's total capital. Party A's subordinated notes have the potential to absorb 45% (\$9 million / \$20 million) of the expected losses. Therefore, Party A has "benefits" from the VIE.

Question 8.9

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, the FASB explained in the Background Information and Basis for Conclusions of FAS 167⁵⁹ that "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.

⁵⁹ Paragraph BC A42 of FAS 167.

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 through 37D and ASC 810-10-55-38 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.

810-10-25-38I

Facts and circumstances shall be considered when assessing the conditions in paragraph 810-10-25-38H. An arrangement that is designed in a manner such that the fee is inconsistent with the reporting entity's role or the type of service would not meet those conditions. To assess whether a fee meets those conditions, a reporting entity may need to analyze similar arrangements among parties outside the relationship being evaluated. However, a fee would not presumptively fail those conditions if similar service arrangements did not exist in the following circumstances:

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

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

810-10-25-38J

Fees or payments in connection with agreements that expose a reporting entity (the **decision maker** or service provider) to risk of loss in the VIE shall not be eligible for the evaluation in paragraph 810-10-25-38H. Those fees include, but are not limited to, the following:

- a. Those related to guarantees of the value of the assets or liabilities of a VIE
- b. Obligations to fund operating losses
- c. Payments associated with written put options on the assets of the VIE
- d. Similar obligations such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE.

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

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.⁶⁰

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. See section 5.4.13.1 for more guidance on assessing whether fees are customary and commensurate. See ASC 810-10-55-205Z through 205AI for an example of identifying the primary beneficiary when an entity receives a fee from a VIE that includes terms and conditions that are not customarily present.

Fee arrangements that expose a decision maker or service provider to risk of loss that the entity was designed to create and pass through to its variable interest holders in the VIE are included when evaluating the benefits criterion, even if those fees are customary and commensurate. 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 (see section 5.4.5)
- ▶ Obligations to fund operating losses (see section 5.4.5)
- ▶ Payments associated with written put options on the assets of the VIE (see section 5.4.5)
- ▶ Liquidity commitments and similar obligations (explicit or implicit) that protect holders of other interests from suffering losses in the VIE (e.g., repurchase provisions) (see section 5.4.5)
- ▶ Certain derivative instruments (see section 5.4.4.1)
- ▶ Certain forward contracts (see section 5.4.4.2)

See section 5.4.13.3 for additional guidance on assessing whether fees expose a reporting entity to risk of loss.

⁶⁰ Paragraph BC42 of ASU 2015-02.

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 staff⁶¹ 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 only substantive terms, transactions and arrangements should be considered in arriving at a consolidation conclusion (see section 3). 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.

The SEC staff has also indicated⁶² 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.

⁶¹ Comments by Arie S. Wilgenburg, SEC Professional Accounting Fellow, at the 2009 AICPA National Conference on Current SEC and PCAOB Developments.

⁶² Comments by Christopher Rogers, SEC Professional Accounting Fellow, at the 2014 AICPA National Conference on Current SEC and PCAOB Developments.

Illustration 8-16: Disproportionate power and benefits

Assume the same facts as in Illustration 8-6, 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 8.10

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. Now, 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 8.11 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 BC A27 of 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 VIE are performed using sound judgment, then the risk of inconsistency should be mitigated to an acceptable level.”

Question 8.12 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 section 6).

Question 8.13 Does a reporting entity that determines that it would not be the primary beneficiary of an entity (after considering the related party guidance in section 9) 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 as discussed in section 4.4, no further analysis is required under the Variable Interest Model. See section 23.2 for further discussion on required disclosures when a reporting entity has a variable interest in a VIE.

Question 8.14 Does the Variable Interest Model affect the 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 (updated June 2023)

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 all of its direct variable interests in the entity and, on a proportionate basis, its indirect variable interests in the entity held through related parties (the term related parties in this paragraph refers to all parties as defined in paragraph 810-10-25-43). For example, if the single decision maker owns a 20 percent interest in a related party and that related party owns a 40 percent interest in the entity being evaluated, the single decision maker's indirect interest in the VIE held through the related party would be equivalent to an 8 percent direct interest in the VIE for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b) (assuming it has no other relationships with the entity). Similarly, if an employee (or de facto agent) of the single decision maker owns an interest in the entity being evaluated and that employee's (or de facto agent's) interest has been financed by the single decision maker, the single decision maker would include that financing as its indirect interest in the evaluation. For example, if a single decision maker's employees have a 30 percent interest in the VIE and one third of that interest was financed by the single decision maker, then the single decision maker's indirect interest in the VIE through the financing would be equivalent to a 10 percent direct interest in the VIE.

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.

810-10-25-44A

In situations in which a single decision maker concludes, after performing the assessment in paragraph 810-10-25-42, that it does not have the characteristics in paragraph 810-10-25-38A, the single decision maker shall apply the guidance in paragraph 810-10-25-44 only when the single decision maker and one or more of its related parties are under common control and, as a group, the single decision maker and those related parties have the characteristics in paragraph 810-10-25-38A.

810-10-25-44B

This paragraph applies to a related party group that has the characteristics in paragraph 810-10-25-38A only when both of the following criteria are met. This paragraph is not applicable for legal entities that meet the conditions in paragraphs 323-740-15-3 and 323-740-25-1.

- a. The conditions in paragraph 810-10-25-44A are not met by a single decision maker and its related parties.
- b. Substantially all of the activities of the VIE either involve or are conducted on behalf of a single variable interest holder (excluding the single decision maker) in the single decision maker's related party group.

The single variable interest holder for which substantially all of the activities either involve or are conducted on its behalf would be the primary beneficiary. The evaluation in (b) above should be based on a qualitative assessment of all relevant facts and circumstances. In some cases, when performing that qualitative assessment, quantitative information may be considered. This assessment is consistent with the assessments in paragraphs 810-10-15-14(c)(2) and 810-10-15-17(d)(2).

Pending Content:

Transition Date: (P) December 16, 2023; (N) December 16, 2024 | **Transition Guidance:** 323-740-65-2

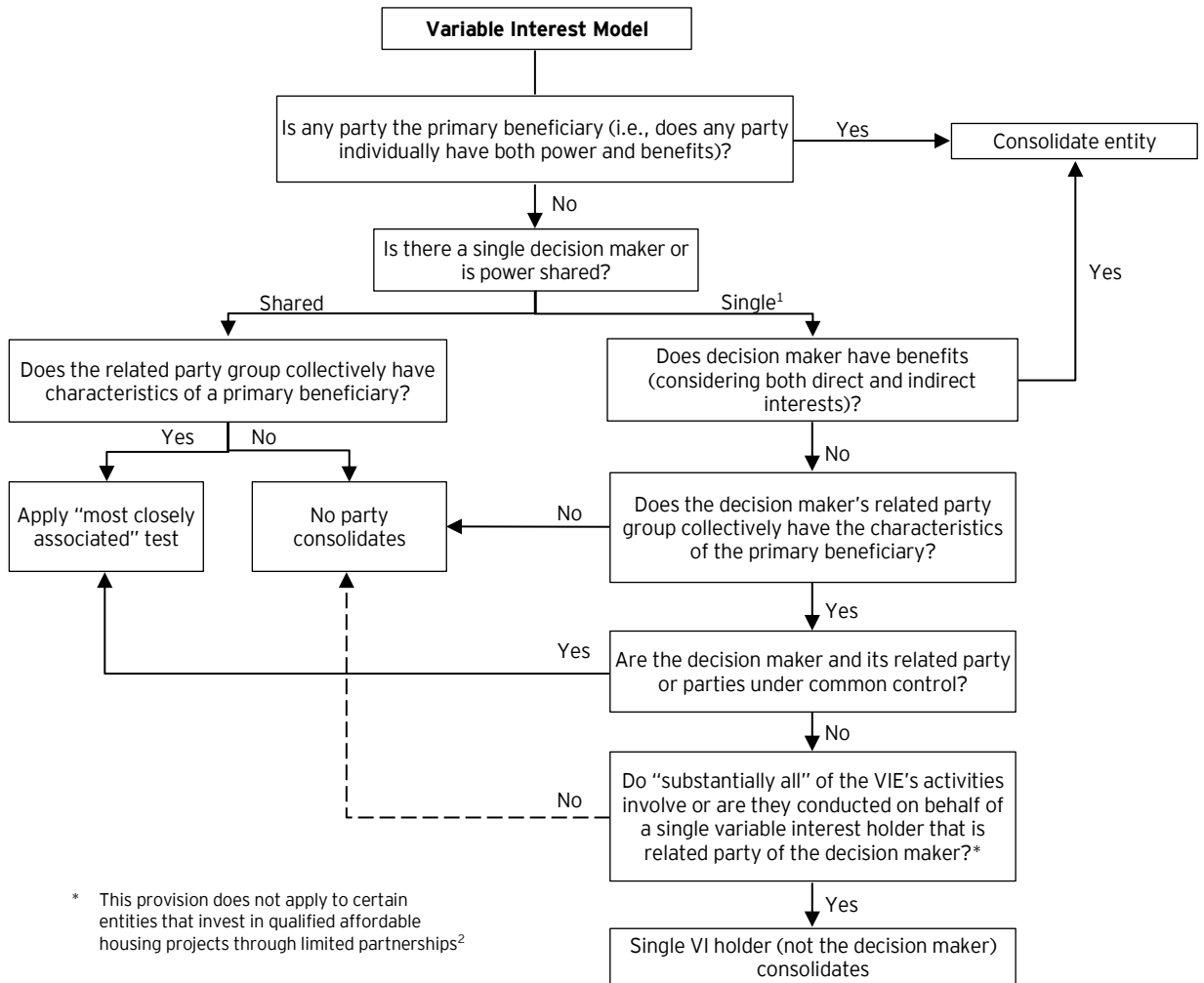
810-10-25-44B

This paragraph applies to a related party group that has the characteristics in paragraph 810-10-25-38A only when both criteria (a) and (b) below are met. This paragraph is not applicable for legal entities that meet the conditions in paragraph 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).

The following flowchart explains how to identify the primary beneficiary, if any, in a related party group, once it is determined that the entity is a VIE. See section 1.1.2 for the complete flowchart illustrating how to assess control.



¹ When multiple parties direct different activities that most significantly impact the VIE's economic performance, one of the parties will be identified as a single decision maker, as discussed in section 8.2.3.6.

² The primary beneficiary provisions of the Variable Interest Model specifically exempt limited partners in tax credit program structures that meet the conditions for applying the proportional amortization method from having to assess whether they benefit from "substantially all" of the entity's activities (ASC 810-10-25-44B). As noted in paragraph BC72 of ASU 2015-02, the FASB was concerned that these investors would be required to consolidate the partnerships, despite not meeting the power test, which would have undermined the objective of ASU 2014-01. The exemption has been limited to investors in low-income housing tax structures, but ASU 2023-02 broadened the scope of the proportional amortization guidance in ASC 323-740 to include equity investments in all tax credit programs that meet certain conditions. Therefore, the adoption of ASU 2023-02 could result in investors in other tax credit structures being exempt from the "substantially all" assessment. For public business entities, ASU 2023-02 is effective for annual and interim periods beginning after 15 December 2023. For all entities other than public business entities, ASU 2023-2 is effective for annual and interim periods beginning after 15 December 2024. Early adoption is permitted for annual and interim periods.

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 section 10. However, if a reporting entity concludes that no party 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 whether 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 (see section 9.2) or whether power is shared (see section 9.3).

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 June 2023)

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 for guidance on determining whether a decision maker has a variable interest and section 9.2.1 for guidance on identifying the primary beneficiary when the single decision maker directs the activities of the VIE through an arrangement that is not a variable interest).

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.

A single decision maker considers the benefits absorbed by an indirect interest in a VIE on a proportionate basis, regardless of whether the decision maker and the related party that holds the interest in the VIE are under common control. Section 2.3 provides guidance on identifying common control.

If a decision maker finances a portion of an employee's or a 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%.

In addition, a decision maker should consider guarantees and other variable interests, including implicit variable interests that create an indirect exposure to the VIE. For example, if a single decision maker guarantees employee loans that are repaid with returns from equity investments in the VIE, this may be considered an indirect variable interest. See Illustration 9-3 for an example.

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 on a proportionate basis regardless of whether the decision maker and the related party that holds the variable interest are 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.

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, consistent with the evaluation in the “anti-abuse” test (see section 7.4.2) and the business scope exception (see section 4.4.4.2).

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.

However, the primary beneficiary provisions of the Variable Interest Model specifically exempt limited partners in tax credit partnerships that meet the conditions for applying the proportional amortization method from having to assess whether they benefit from “substantially all” of the VIE’s activities (ASC 810-10-25-44B), as discussed in section F.3. The exemption has been limited to investors in low-income housing tax credit (LIHTC) structures, but ASU 2023-02 broadened the scope of the proportional amortization guidance in ASC 323-740 to include equity investments in all tax credit programs that meet certain conditions. Therefore, the adoption of ASU 2023-02 could result in investors in other tax credit structures being exempt from the “substantially all” assessment.



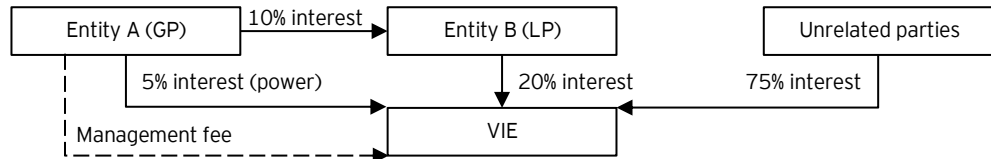
FASB amendment

In March 2023, the FASB issued Accounting Standards Update (ASU) 2023-02, *Investments-Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*, allowing entities to apply the proportional amortization method to equity investments in all tax credit programs that meet the conditions in ASC 323-740-25-1, rather than just investments in qualified affordable housing projects that generate LIHTCs. Under the amended guidance, entities can elect the proportional amortization method on a tax-credit-program-by-tax-credit-program basis. If elected, the method should be applied consistently to all investments in the tax credit program. The ASU also made other changes to the guidance in ASC 323-740.

The guidance is effective for public business entities for fiscal years beginning after 15 December 2023, and interim periods within those fiscal years, and for all other entities for fiscal years beginning after 15 December 2024, and interim periods within those fiscal years. Early adoption is permitted for all entities in any interim period. See our Technical Line publication, [***Expanded use of the proportional amortization method for equity investments in tax credit programs***](#), for more discussion.

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.



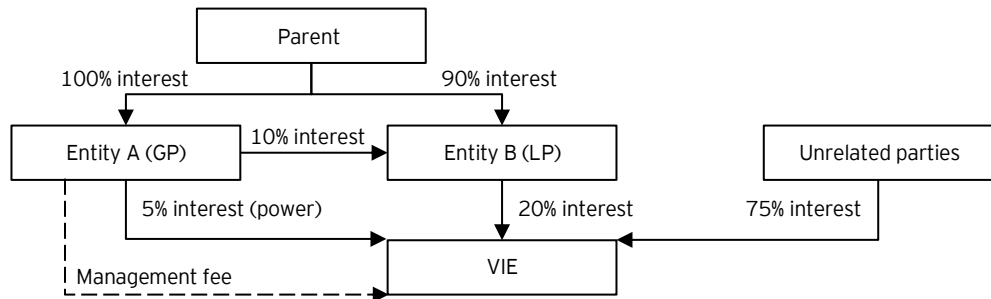
Analysis

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. However, Entity A should consider the VIE disclosure requirements with respect to its variable interest in 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.



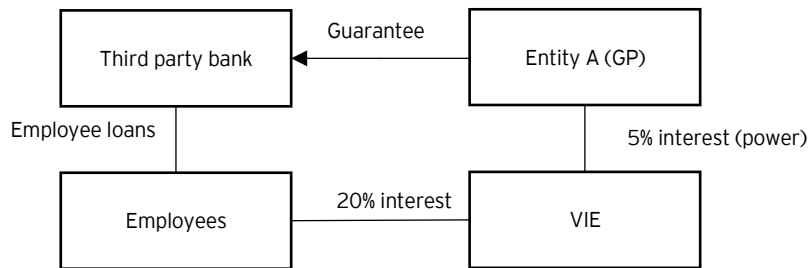
Analysis

The fee is not a variable interest. The decision maker's total other interests for determining whether its fee is a variable interest would be (7% = 5% direct + 2% indirect (10% x 20%)), which it likely would conclude is not significant. See section 5.4.13.2.1 for more guidance.

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. As a result, the related party group under common control 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). Additionally, the entity that determines it is not the primary beneficiary would still need to consider the VIE disclosure requirements with respect to its variable interest in the VIE.

Illustration 9-3: Primary beneficiary determination – single decision maker with an indirect interest through a guarantee on employee loans

Entity A forms a limited partnership. Assume the same facts as in Illustration 9-1, except that the employees of Entity A hold 20% of the limited partnership equity interests, and other investors hold the remaining interests. Employees may borrow their required capital commitment for their equity interests from a third-party bank. Entity A provides, separate from its fee arrangement, a guarantee to the third-party bank on any borrowed funds on behalf of its employees.



Analysis

Entity A would have power through its equity interest.

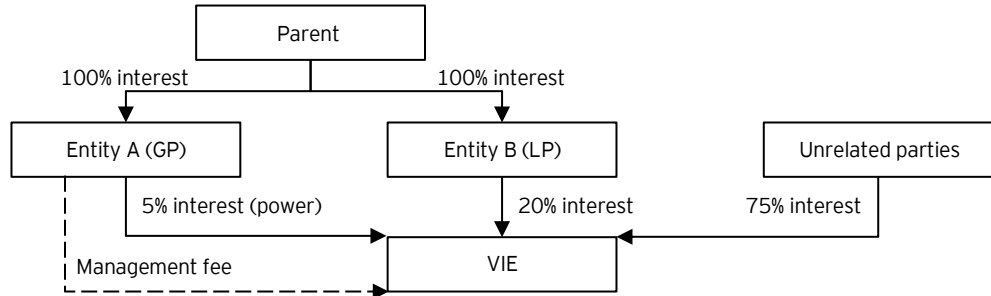
The fee is not a variable interest because it is commensurate with the services provided, includes only customary terms and conditions, and does not expose Entity A to risk of loss. The fee arrangement is with the limited partners of the VIE, whereas the guarantee that exposes Entity A to risk of loss is a separate arrangement entered into with a third-party bank.

We generally believe that the guarantee to the third-party bank creates an indirect variable interest (or an implicit variable interest) because it absorbs the variability of the employees' equity interests in the VIE. In substance, the guarantee of a loan on behalf of employees is the same as if Entity A had financed the loans directly.

Therefore, Entity A likely would conclude that its variable interests (5% direct + 20% indirect interest through the guarantee) are significant. Since it has power and benefits through direct and indirect interests, Entity A would be the primary beneficiary and would consolidate the VIE.

Illustration 9-4: Primary beneficiary determination – single decision maker under common control with no indirect benefits through a related party and power held through general partner interest

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. See section 5.4.13.2.1 for more guidance.

While Entity A would have power through its equity 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). Additionally, the entity that determines it is not the primary beneficiary would still need to consider the VIE disclosure requirements with respect to its variable interest in the VIE.

9.2.1

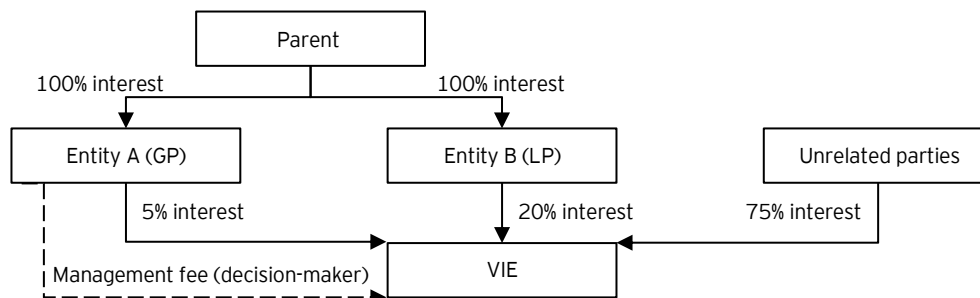
Single decision maker without a variable interest (added June 2023)

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 and would not consolidate the VIE. However, additional analysis may need to be performed when the related party group under common control meets the economics criterion. In these cases, we believe the parent should consolidate the VIE if it concludes that its controlling financial interest in the related party group gives it power and benefits based on the purpose and design of the VIE and the substantive terms of the arrangement.

ASC 810 does not address how a related party under common control with the decision maker should evaluate the VIE for consolidation in its standalone financial statements. We believe the related party with economics that is under common control with the decision maker should evaluate whether substantially all of the VIE's activities either involve or are conducted on its behalf. If so, it should consolidate the VIE in accordance with ASC 810-10-25-44B (see section 9.1).

Illustration 9-5: Primary beneficiary determination – single decision maker under common control with no indirect benefits through a related party and no power held through a variable interest

Entity A forms a limited partnership with a related party, Entity B, that is under common control with Entity A under Parent. Entity A holds a 5% general partnership equity interest, but makes decisions based on its management contract, not its general partnership interest. For providing management services, Entity A receives a fee that is commensurate with the services provided and includes only customary terms and conditions. Entity B holds a 20% limited partnership equity interest, and the remaining interests are dispersed among other investors. Assume the limited partnership is a VIE.



Analysis

The fee is not a variable interest as discussed in Illustration 9-4 and would be excluded from the benefit analysis because it is customary and commensurate. Entity A would not have power to direct the activities that most significantly impact the entity's economic performance because it makes all its decisions for the VIE through an arrangement that is not a variable interest. As a result, Entity A would not consolidate the VIE.

However, Parent has a controlling financial interest in Entity A and Entity B, and as a result, it has the power to direct the decisions made by its common controlled subsidiaries. Although Parent 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 should consolidate the VIE.

Entity B evaluates the VIE for consolidation following the guidance in ASC 810-10-25-44B and determines that substantially all of the activities of the VIE neither involve nor are conducted on its behalf. Therefore, Entity B does not consolidate the VIE.

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.

When assessing whether power is shared among related parties, factors to consider include:

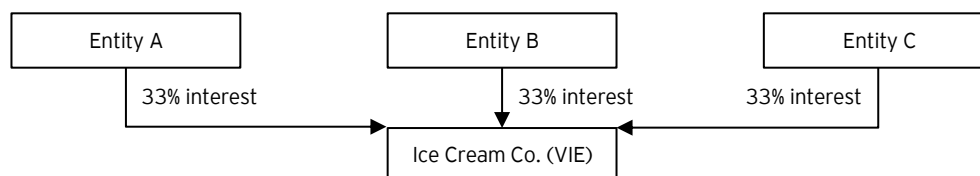
- ▶ Whether the party or parties have the ability to *make decisions* about the activities that significantly impact the VIE's economic performance, rather than which party is responsible for the *execution* or day-to-day management of those decisions
- ▶ The mechanisms for remediating disputes or ties, as discussed in Question 8.4
- ▶ The substance of the arrangements, which includes understanding the purpose and the design of the VIE and the arrangements

The SEC staff has been 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.⁶³

Illustration 9-6: 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.



Analysis

In this example, power is shared because the decisions about the activities that most significantly 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.

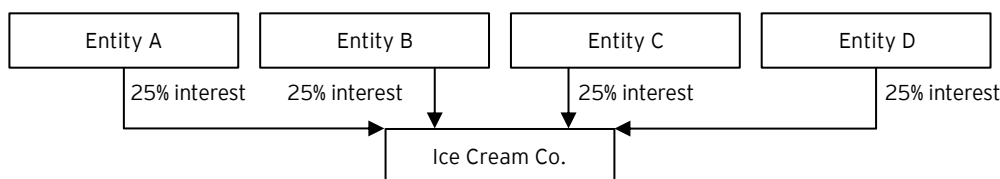
⁶³ Comments by Christopher F. Rogers, SEC Professional Accounting Fellow, and Wesley R. Bricker, SEC Professional Accounting Fellow, at the 2014 and 2010 AICPA National Conference on Current SEC and PCAOB Developments, respectively, and by Paul A. Beswick, Deputy Chief Accountant, at the 29th Annual SEC and Financial Reporting Institute Conference.

Illustration 9-7 addresses when power is not shared because one party has the power to unilaterally direct an activity that significantly affects the VIE's economics.

Illustration 9-7: Power is not shared but is held by related parties

Four related parties, Entity A, Entity B, Entity C and Entity D, formed an entity, Ice Cream Co., to manufacture, distribute and sell ice cream. Each entity paid cash for 25% of the equity of Ice Cream Co. (considered equity investment at risk) upon its formation. 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. Ice Cream Co. is a VIE due to insufficient equity at risk.

The decisions about manufacturing, distributing and selling ice cream significantly impact the VIE's economic performance. All decisions related to distributing and selling ice cream require the unanimous consent of Entity A, Entity B and Entity C, and that consent is determined to be substantive. However, Entity D can unilaterally make decisions about manufacturing ice cream. Assume that although the parties are related, the decision-making ability held by each party is deemed to be substantive (see section 3).



Analysis

In this example, power is **not** shared because Entity D has both power (the ability to make decisions about manufacturing ice cream) and benefits, regardless of whether the decisions made collectively by Entity A, Entity B and Entity C (decisions about distributing and selling ice cream) more significantly impact the economic performance of the VIE. This is because once the significant activities are identified, that population of activities is used to identify whether any party has both power and benefits. Since power is not shared, the related party tie-breaker test (described in section 9.5) does not apply. Instead, Entity D would be identified as the primary beneficiary of Ice Cream Co., because it has the power to direct a significant activity (manufacturing ice cream) unilaterally, and it has benefits through its 25% interest. See section 8.2.3.6 for additional guidance when multiple parties direct different activities.

9.4

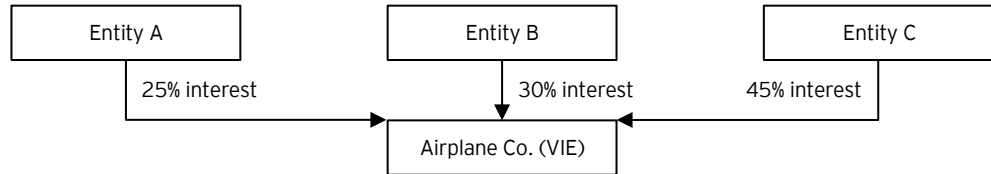
Multiple decision makers within the related party group

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. In this case, although a related party group that is not under common control may collectively have both power and benefits, the related party tie-breaker test (the most closely associated test) described in section 9.5 only is performed when there is shared power or a single decision maker, based on the guidance in ASC 810-10-25-44 through 44B.

However, before reaching this conclusion, we believe that in those situations a reporting entity needs to first 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 9-8: Multiple decision makers in a related party group not under common control

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.

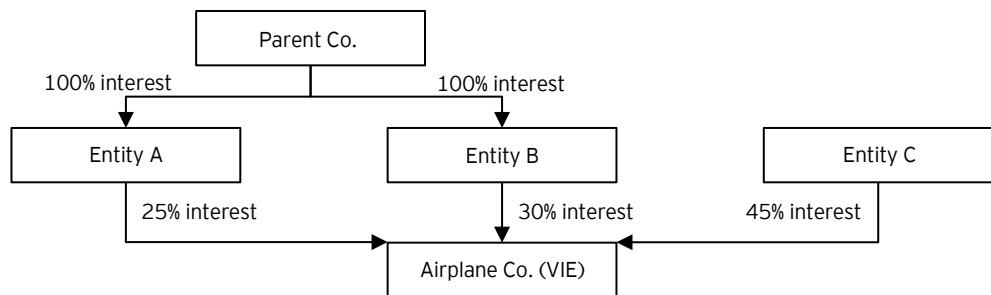


Analysis

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 9-9: Multiple decision makers in a common control group

Assume the same facts as in Illustration 9-8, except that Entity A and Entity B are wholly owned subsidiaries of Parent Co.



Analysis

As in Illustration 9-8, 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

Excerpt from Accounting Standards Codification

Consolidation – Overall

Recognition – Variable Interest Entities

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.

As shown in the flowchart in section 9.1, determining which party in a related party group is most closely associated with a VIE is only⁶⁴ required when:

- ▶ A single decision maker and a related party under common control collectively have the characteristics of a controlling financial interest (i.e., power and benefits) (see section 9.2).
- ▶ Power is shared among a related party group (see section 9.3).

However, the related party tie-breaker test is *not* applied if any party in a related party group individually has power and benefits, even if other related parties also have variable interests in the VIE.⁶⁵ The party that individually has power and benefits is the primary beneficiary, as discussed in section 8.1. A reporting entity also would not apply the related party tie-breaker test if it does *not* have a variable interest in a VIE (see Question 5.4).

The member of the group that is “most closely associated” with the VIE is the primary beneficiary. The Variable Interest Model provides four factors to consider in determining which party is most closely associated with a VIE:

- ▶ The existence of a principal-agency relationship between parties within the related party group (see section 9.5.1)
- ▶ The relationship and significance of the activities of the VIE to the various parties within the related party group (see section 9.5.2)
- ▶ A party's exposure to the variability associated with the anticipated economic performance of the VIE (see section 9.5.3)
- ▶ The design of the VIE (see section 9.5.4)

⁶⁴ This was a significant change in ASU 2015-02 from the model in FAS 167.

⁶⁵ See ASC 810-10-25-44 and -44A and comments by Christopher F. Rogers, SEC Professional Accounting Fellow, at the 2014 AICPA National Conference on Current SEC and PCAOB Developments.

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, considered in the context of the purpose and design of the VIE. 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.⁶⁶

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.

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 section 10), we do not believe any one factor is determinative. The determination should be based on all relevant facts and circumstances.

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?

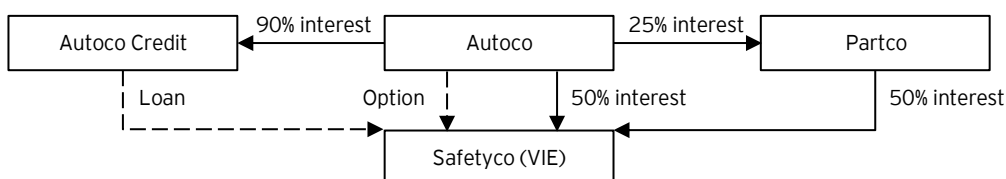
⁶⁶ Comments by Jane D. Poulin, Associate Chief Accountant, at the 2004 AICPA National Conference on SEC Developments. We believe that references to FIN 46(R) in the speech also would apply to the current Variable Interest Model.

- ▶ 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 9-10: 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. Autoco consolidates Autoco Credit because it holds 90% of Autoco Credit's common stock. 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.

9.5.3 Exposure to variability associated with the anticipated economic performance of the VIE

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.

9.5.4 Purpose and design

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?

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.

9.6 One member of a related party group not clearly identified

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.

Illustration 9-11: 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.

10 Related parties and de facto agents

10.1 Introduction

In the Variable Interest Model and this FRD, 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.⁶⁷ The Variable Interest Model requires a reporting entity to consider the involvement of related parties and de facto agents in multiple aspects of the consolidation analysis, as shown in the following table:

	Consideration	Guidance
Scope	▶ Using the not-for-profit organization scope exception	▶ Section 4.4.1.2
	▶ Using the business scope exception	▶ Section 4.4.4
Identifying variable interests	▶ Identifying implicit variable interests	▶ Section 5.4.12
	▶ Determining whether fees paid to decision makers or service providers are variable interests due to the significance of other interests held	▶ Section 5.4.13
Determining whether an entity is a VIE	▶ Determining whether the equity at risk is sufficient if equity interests were financed for the reporting entity by other parties	▶ Section 7.2.2.4
	▶ Determining whether an entity’s equity holders, as a group, lack the power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance	▶ Section 7.3.1.3
	▶ Determining whether an entity was established with non-substantive voting rights	▶ Section 7.4.3
Determining the primary beneficiary	▶ Determining the primary beneficiary if the related party group collectively has the characteristics of a controlling financial interest, when no party individually has both power and benefits	▶ Section 9

Section 10.2 and section 10.3 provide guidance on identifying related parties and de facto agents, respectively, when applying the Variable Interest Model.

⁶⁷ For example, when determining whether an entity is a VIE, the anti-abuse clause excludes certain de facto agents from the analysis, as discussed in section 7.4.3.

10.2 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. 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 section 9).

10.3 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.
 1. Subparagraph superseded by Accounting Standards Update No. 2009-17.
 2. Subparagraph superseded by Accounting Standards Update No. 2009-17.
- 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 ASC 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). In other cases, the evaluation of whether a de facto agency relationship exists requires 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.

10.3.1

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

Under the Variable Interest Model, a party that receives its interests as a contribution or a loan from the reporting entity is considered a de facto agent of the reporting entity. Like the other criteria for being a de facto agent, this criterion was established to prevent a reporting entity from structuring a transaction to avoid consolidation by having another party hold the variable interest in the VIE that the reporting entity is exposed to indirectly.

Often, it is clear whether this criterion is met. However, in some cases, judgment may be required to determine whether an arrangement creates an in-substance loan or contribution. For example, this might be the case when the reporting entity agrees to buy the other party's interest in the VIE in the future, or the other party can put its interest in the VIE to the reporting entity.

The following factors may be relevant in determining whether an in-substance loan exists and creates a de facto agency relationship⁶⁸:

- ▶ Whether the other party's equity interest was directly financed by the reporting entity (i.e., whether the arrangement was structured as a loan from a legal perspective)
- ▶ Whether the other party had an equity interest in the VIE before the reporting entity

⁶⁸ These factors are consistent with the considerations evaluated by the staff in a fact pattern that was discussed by Damon Romano, SEC Professional Accounting Fellow, at the 2020 AICPA Conference on Current SEC and PCAOB Developments.

- ▶ Whether the other party needed the arrangement to continue participating in the VIE (e.g., to satisfy its obligations under a capital call)
- ▶ The purpose of the arrangement

This is not an exhaustive list of factors to consider. A judgment should be made based on all facts and circumstances, including the purpose and the design of the arrangement and the VIE.

10.3.2

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 (i.e., a “lock-up”) 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.

Illustration 10-1: Party can transfer its interest in the VIE without prior approval

Entity A, the reporting entity, is evaluating whether Entity B is considered its de facto agent. Both entities hold equity interests in a VIE. Entity B has the ability to sell or transfer its equity interest in the VIE to a third party without the prior approval of Entity A. However, Entity B is required to receive approval from Entity A before it can encumber its equity interest. Entity A and Entity B do not have any other relationships.

Analysis

If Entity B can obtain all or most of the cash inflows (i.e., realize the economic rewards) by selling or transferring its equity interest in the VIE, Entity B would not be constrained by the sale or transfer restrictions, even though Entity A’s approval is required to encumber the equity interest. Therefore, Entity B is not a de facto agent of Entity A under this criterion.

10.3.2.1 **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, sometimes referred to as a "one-way lock-up"). 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 section 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 section 9.

10.3.2.2 **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, an approval that cannot be unreasonably withheld or restrictions on selling interests to competitors.

10.3.2.2.1 ***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 with 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.

10.3.2.2.2 ***Right of first offer***

A right of first offer gives the holder the right to receive notice from the selling party before it sells its interest to a third party. That notice constitutes an offer by the selling party to sell its interest for the price, terms and conditions set forth in the notice. The holder of the right of first offer can decide either to accept or reject the terms of the offer. If the holder does not accept the offer, it generally is deemed to have consented to the proposed sale, and the seller 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.

10.3.2.2.3 **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.

10.3.2.2.4 **Restrictions on selling interests to competitors**

A party may have an agreement that it is restricted from selling or transferring its interest in a legal entity to competitors of a party in the arrangement, but it could sell, transfer or encumber its interest to another buyer that is not a competitor (e.g., a private equity fund). As discussed in paragraph BC D43 of FIN 46(R), “if the right of prior approval is designed solely to prevent transfer of the interest to a competitor or to a less creditworthy, or otherwise less qualified, holder, and such parties are not the only potential purchasers of the interest, the right would not create a de facto agency relationship.” However, if the only potential buyers in the market for that interest are buyers to which the seller cannot sell its interest, that would indicate that a de facto agency relationship exists.

10.3.3 **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. 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.⁶⁹

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.

10.3.4 **Separate accounts of insurance entities 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 entity should not:

- ▶ Consider any separate account interests held for the benefit of policyholders to be the insurance entity’s interests
- ▶ Combine any separate account interests held for the benefit of policyholders with the insurance entity’s general account interest in the same investment

⁶⁹ See paragraphs C38 of FIN 46 and D41 of FIN 46(R).

However, separate account interests held for the benefit of a related party policyholder should be combined with the insurance entity'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 entity (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 entity (and its other related parties), unless the employee benefit plan is used in an effort to circumvent the provisions of the Variable Interest Model

See Question 23.4 for guidance when an insurer concludes that an investment fund should be consolidated and a portion of the fund is owned by the insurer's separate accounts.

11 Voting Model and consolidation of entities controlled by contract

11.1 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), 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 Model⁷⁰ 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. The term "voting interest entity" is not defined but has emerged in practice to mean an entity that is not a VIE.

⁷⁰ 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 sections 11.2.1 and 11.2.2, 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 11.4 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.

11.1.1

SEC regulations on consolidation

Excerpt from Accounting Standards Codification

Consolidation – Overall

SEC Materials

810-10-S99-2 (Regulation S-X Rule 3A-02, Consolidated Financial Statements of the Registrant and its Subsidiaries)

The following is the text of Regulation S-X Rule 3A-02, Consolidated Financial Statements of the Registrant and its Subsidiaries (17 CFR 210.3A-02).

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 financial statements are more meaningful than separate financial 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. Other particular facts and circumstances may require combined financial statements, an equity method of accounting, or valuation allowances in order to achieve a fair presentation.

- (a) **Majority ownership:** Among the factors that the registrant should consider in determining the most meaningful presentation is majority ownership. Generally, registrants shall consolidate entities that are majority owned and shall not consolidate entities that are not majority owned. The determination of *majority ownership* requires a careful analysis of the facts and circumstances of a particular relationship among entities. In rare situations, consolidation of a majority owned subsidiary may not result in a fair presentation, because the registrant, in substance, does not have a controlling financial interest (for example, when the subsidiary is in legal reorganization or in bankruptcy). In other situations, consolidation of an entity, notwithstanding the lack of technical majority ownership, is necessary to present fairly the financial position and results of operations of the registrant, because of the existence of a parent-subsidiary relationship by means other than record ownership of voting stock ...

Excerpt from SEC Regulation S-X

Application of Regulation S-X

210.1-02 Definitions of terms used in Regulation S-X

- (g) **Control.** The term *control* (including the terms *controlling*, *controlled by* and *under common control with*) 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.

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.

11.1.2

Scope of the Voting 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.
 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).
- 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.
- 3. Subparagraph superseded by Accounting Standards Update No. 2013-08.
- b. Subparagraph superseded by Accounting Standards Update No. 2015-02.
- c. Subtopic 810-30 shall be applied to determine the consolidation status of a research and development arrangement.
- d. The Consolidation of Entities Controlled by Contract Subsections of this Subtopic shall be applied to determine whether a contractual management relationship represents a controlling financial interest.
- e. Paragraph 710-10-45-1 addresses the circumstances in which the accounts of a rabbi trust that is not a VIE (see the Variable Interest Entities Subsections for guidance on VIEs) shall be consolidated with the accounts of the employer in the financial statements of the employer.

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 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 when a non-investment company is providing services to the investment company, as discussed in ASC 946-810-45-3 and in Appendix G)
- ▶ When the reporting entity is involved in a research and development arrangement in ASC 810-30 (as discussed in section 4.1 of this publication, we believe it will be relatively rare that reporting entities apply ASC 810-30. See section R7.2.7, ***Consolidation considerations for R&D arrangements in which all funds are provided by a sponsor***, of our Accounting Manual for more guidance.)
- ▶ 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.

11.2

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.

11.2.1

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.

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.

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 11.3 for further discussion of conditions when control does not rest with the majority owner.

11.2.1.1

Consolidation of a not-for-profit organization

A not-for-profit organization is evaluated for consolidation under the Voting Model or the Entities Controlled by Contract subsections of ASC 810, unless a reporting entity is using the not-for-profit organization (as defined in the Master Glossary) to circumvent the Variable Interest Model. Under the Voting Model, the usual condition for a controlling financial interest is ownership of a majority voting interest in an entity.

We are aware of two primary views⁷¹ applied in practice to determine whether a for-profit entity has a controlling financial interest under the Voting Model in a not-for-profit entity that is a charitable foundation under section 501(c)(3) of the Internal Revenue Code (IRC) and meets the definition of a not-for-profit entity in the Master Glossary of the ASC (see section 4.4.1). We believe both views are acceptable as an accounting policy election, which should be applied consistently.

One view is that a for-profit entity does not have a controlling financial interest under ASC 810 if it does not have an ownership interest representing a residual or other direct economic interest in the net assets of the not-for-profit organization and therefore would not consolidate it. This is because under section 501(c)(3) of the IRC, none of the earnings may inure to a private shareholder or individual,⁷² including the sponsoring for-profit entity (unlike an ownership interest in a for-profit entity).

Another view is that a for-profit entity has a controlling financial interest under ASC 810 when it has the power to make decisions for the not-for-profit organization (e.g., the for-profit entity has control over the not-for-profit organization's board of directors through its sole corporate membership) and therefore would consolidate it. This view is based on ASC 810-10-15-8, which notes that "for legal entities other than limited partnerships... [the] power to control may also exist... by contract, lease, agreement with other stockholders, or by court decree." For-profit entities applying this view also may look to the guidance in Rule 1-02(g) of Regulation S-X, which 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."

Under the second view, when evaluating whether the reporting entity controls the board of directors of the not-for-profit organization, the following factors may be relevant:

- ▶ How the directors are selected (e.g., by the reporting entity, an independent search firm)
- ▶ The length of service of directors and the selection of replacement directors
- ▶ The director's employment by the reporting entity or financial interests in the reporting entity (e.g., employee, corporate pension plan participant, stock option holder)

The FASB recently discussed the diversity in practice and decided not to address it and acknowledged that for-profit entities can make an accounting policy election in the absence of specific US GAAP. Some members of the FASB stated that if a for-profit reporting entity previously applied an accounting policy that has resulted in consolidation of a not-for-profit organization that is not being used to circumvent the Variable Interest Model, the for-profit entity could consider a voluntary change in accounting principle that would result in deconsolidation,⁷³ which two board members stated would be a preferable policy.⁷⁴ See section 3 of our FRD, ***Accounting changes and error corrections***, for guidance on a voluntary change in accounting principle under ASC 250.

In addition, it is important to disclose any commitments to the not-for-profit or transactions between the reporting entity and the not-for-profit (e.g., funding, loaning employees, use of corporate assets or resources) if required under ASC 440, ASC 850 or other applicable US GAAP.

⁷¹ In addition, some entities may analogize to ASC 958-810 as an accounting policy election, as stated in the tentative Board Decisions, 24 March 2021 FASB Meeting

⁷² <https://www.irs.gov/charities-non-profits/charitable-organizations/exemption-requirements-501c3-organizations>

⁷³ Tentative Board Decisions, 24 March 2021 FASB Meeting

⁷⁴ Comments made by Richard R. Jones, Chair, and James L. Kroeker, Vice Chairman at the 24 March 2021 FASB Meeting.

11.2.2

Voting Model: Control of limited partnerships and similar entities

Excerpt from Accounting Standards Codification**Consolidation – Overall*****Scope and Scope Exceptions – General*****810-10-15-8A**

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.

Recognition**810-10-25-1A**

Given the purpose and design of limited partnerships, **kick-out rights** through voting interests are analogous to voting rights held by shareholders of a corporation. Consolidation is appropriate if a reporting entity has a controlling financial interest in a limited partnership and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest in a limited partnership is ownership of a majority of the limited partnership's kick-out rights through voting interests, but, in some circumstances, control does not rest with the majority owner.

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.

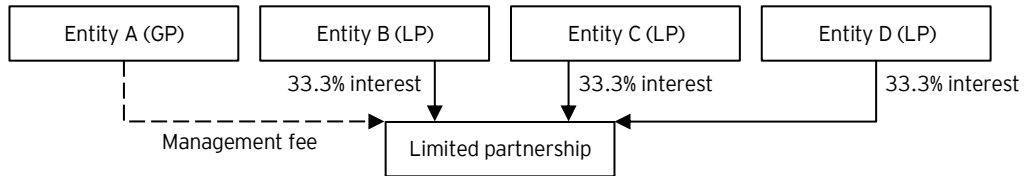
The presence of such rights indicates that the entity is structured with substantive voting rights. In limited partnerships, kick-out rights are analogous to voting rights held by shareholders of a corporation because these rights enable the limited partner(s) to remove the general partner without cause, 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. A general partner generally would not consolidate a voting interest entity. Rather, 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 11-1: 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).

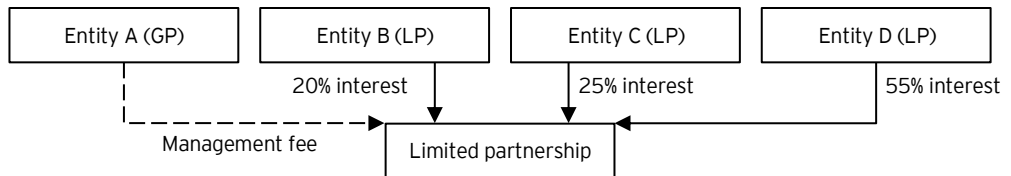


Analysis

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 11-2: Voting Model: limited partner consolidates

Assume the same facts as in Illustration 11-1, except that Entity B, Entity C and Entity D hold 20%, 25% and 55% of the limited partnership interests respectively.



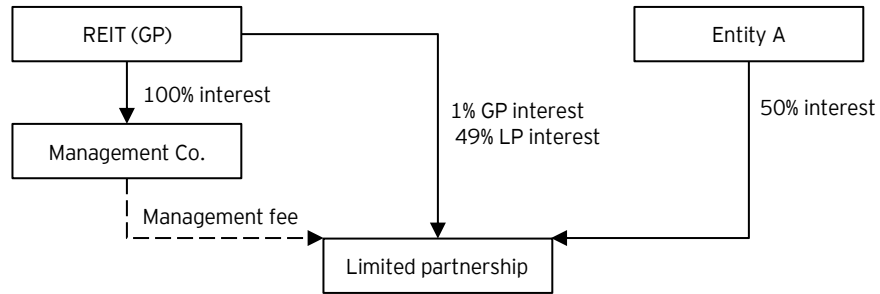
Analysis

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 11-3: Voting Model: real estate investment trust (REIT)

A 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.

11.2.2.1**Not-for-profits that are the general partner of a for-profit limited partnership****Excerpt from Accounting Standards Codification****Not-for-Profit Entities, Consolidation****Recognition****General Partners or Limited Partners That Control a Limited Partnership****958-810-25-12**

The general partners in a **limited partnership** are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.

958-810-25-14

The assessment of whether the rights of the limited partners overcome the presumption of control by the general partners is a matter of judgment that depends on facts and circumstances. The general partners do not control the limited partnership if the limited partners have either of the following:

- a. Substantive **kick-out rights**
- b. Substantive **participating rights**.

958-810-25-15

If the limited partners have substantive kick-out rights or substantive participating rights, the presumption of control by the general partners is overcome and each of the general partners shall account for its investment in the limited partnership using the equity method of accounting. Topic 323 provides guidance on the equity method of accounting.

NFPs are not in the scope of the Variable Interest Model. Under ASC 958-810, an NFP that is a general partner of a for-profit limited partnership or similar entity is presumed to control a limited partnership unless the limited partners have substantive kick-out rights or substantive participating rights. Kick-out rights are substantive if they can be exercised by a simple majority vote or a lower threshold of the limited partners' voting interests and there are no significant barriers from preventing the limited partners from exercising those rights if they choose to do so. See ASC 958-810 for more guidance on assessing the substance of kick-out rights and participating rights.

The assessment of whether the rights of the limited partners overcome the presumption of control by the general partner is a matter of judgment that depends on facts and circumstances.

11.2.3 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 11-4: 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.

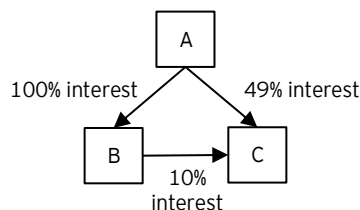
11.2.4 Evaluating indirect control

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 11-5: Evaluating indirect control

Example 1

Company A owns 100% of Company B and 49% of Company C. Company B owns 10% of Company C.

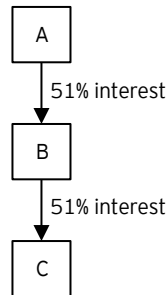


Analysis

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.

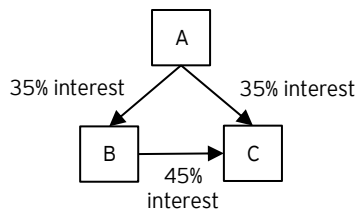
**Analysis**

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 11-6: 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**

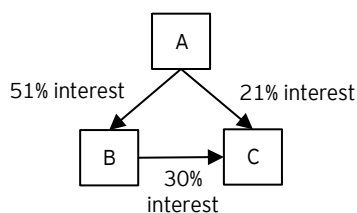
Company A has an economic interest of 50.75% in Company C (its 35% direct interest, plus its 35% of Company B's 45% direct interest in Company C). However, Company A does not have a controlling financial interest in Company C, either directly or indirectly.

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 11-7: 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.

11.2.5 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 section 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.

11.2.6 Control when owning less than a majority of voting shares

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. Other particular facts and circumstances may require combined financial statements, an equity method of accounting, or valuation allowances in order to achieve a fair presentation.

- (a) *Majority ownership*: Among the factors that the registrant should consider in determining the most meaningful presentation is majority ownership. Generally, registrants shall consolidate entities that are majority owned and shall not consolidate entities that are not majority owned. The determination of *majority ownership* requires a careful analysis of the facts and circumstances of a particular relationship among entities. In rare situations, consolidation of a

majority owned subsidiary may not result in a fair presentation, because the registrant, in substance, does not have a controlling financial interest (for example, when the subsidiary is in legal reorganization or in bankruptcy). In other situations, consolidation of an entity, notwithstanding the lack of technical majority ownership, is necessary to present fairly the financial position and results of operations of the registrant, because of the existence of a parent-subsidiary relationship by means other than record ownership of voting stock ...

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 section 7 for guidance on determining whether an entity is a VIE.

Illustration 11-8: 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 section 7 for guidance on determining whether an entity is a VIE.

11.2.6.1

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 11-9: 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.

11.3 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 11.3.1 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 11.3.2 for further discussion on evaluating the effect of noncontrolling rights).

11.3.1 Foreign currency exchange restrictions

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; as such, 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 staff⁷⁵ 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.

11.3.2 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

⁷⁵ Comments by Christopher D. Semesky, SEC Professional Accounting Fellow, at the 2015 AICPA National Conference on Current SEC Developments.

shareholder refers to one or more noncontrolling shareholders and the terms *limited partner* and *general partner* refer to one or more limited or general partners. Paragraph 810-10-15-10(a)(1)(iv) explains that those noncontrolling rights may have little or no impact on the ability of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the investee's operations or assets, or, alternatively, those rights may be so restrictive as to call into question whether control rests with the majority owner.

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 certain significant financial and operating decisions of the investee that are made in the **ordinary course of business**. Effective participation means the ability to block significant decisions proposed by the investor who has a majority voting interest or the general partner. That is, control does not rest with the majority owner because the investor with the majority voting interest cannot cause the investee to take an action that is significant in the ordinary course of business if it has been vetoed by the noncontrolling shareholder. Similarly, for limited partnerships, control does not rest with the limited partner with the majority of kick-out rights through voting interests if the limited partner cannot cause the general partner to take an action that is significant in the ordinary course of business if it has been vetoed by other limited partners. This assessment of noncontrolling rights shall be made at the time a majority voting interest or a majority of kick-out rights through voting interests is obtained and shall be reassessed if there is a significant change to the terms or in the exercisability of the rights of the noncontrolling shareholder or limited partner.

810-10-25-14

An entity that is not controlled by the holder of a majority voting interest or holder of a majority of kick-out rights through voting interests because of noncontrolling shareholder or limited partner veto rights described in paragraphs 810-10-25-2 through 25-13 and 810-10-55-1 is not a VIE if the shareholders or partners as a group (the holders of the equity investment at risk) have the power to control the entity and the equity investment meets the other requirements of paragraphs 810-10-15-14 and 810-10-25-45 through 25-47, as applicable.

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 11.3.2.1 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 11.3.2.2 for further discussion). Significant judgment is required to determine whether minority rights represent substantive participating rights or protective rights.

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 section 7 for further discussion of the characteristics of a VIE).

11.3.2.1

Participating rights

Excerpt from Accounting Standards Codification

Consolidation – Overall

Glossary

810-10-20

Ordinary Course of Business

Decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out 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 does not include self-dealing transactions.

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 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 11.3.2.2 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.

11.3.2.1.1

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 in the ordinary course of business, which will depend on the purpose and design of the entity. Further, for noncontrolling rights to be considered substantive, these rights must have no significant barriers to exercise (e.g., significant penalties, certain call options and buy-sell clauses⁷⁶ or other hurdles making it difficult or unlikely that they could be exercised). Judgment is required when assessing whether there are significant barriers to exercising a right.

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.

⁷⁶ See Example 5 in Illustration 11-10 and Illustration 11-11 for more guidance on evaluating a buy-sell clause.

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 11.3.2.2 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 810-10-25-13 and ASC 810-10-55-1, illustrate how to determine whether participating rights are substantive:

Illustration 11-10: Evaluating whether noncontrolling rights are substantive

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 a minority owner of the limited partner of a voting interest entity.

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 buy-sell clause)

A majority owner that has a contractual right to buy out the interest of the minority owners for fair value or less 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.

It typically is **not** prudent or feasible for a majority owner to exercise its right under a buy-sell clause that has a purchase price of **more** than fair value. However, even if the exercise price is fair value **or less**, it may not be prudent, feasible or substantially within the control of the majority owner to exercise its rights under a buy-sell clause. Judgment is required when making this assessment and, accordingly, when determining whether the rights held by the minority owners are non-substantive.

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.

The following example, derived from an SEC staff speech, illustrates an assessment of whether a buy-sell clause creates a significant barrier to exercising a participating right⁷⁷:

Illustration 11-11: Evaluating whether a buy-sell clause creates a significant barrier to exercising a participating right

Two investors established a limited liability corporation with governing provisions that are the equivalent of a corporation. The majority owner provides the funding for investments, and the minority owner identifies the investment opportunities and manages the investments. The majority owner receives a higher distribution of earnings until it achieves a stated rate of return, after which the two parties receive a more equal distribution of earnings.

The minority owner's approval is required to make certain significant decisions, including approval of operating and capital budgets, which is a participating right. However, if the minority owner does not approve one of these decisions, either party can acquire the other party's shares (i.e., there is a buy-sell clause) at fair value, or the minority owner can consent to the decision, subject to disagreement.

In this fact pattern, the existence of the buy-sell clause was determined to not create a significant barrier that prevents the minority owner from exercising the participating right. Therefore, since the minority owner holds a substantive participating right, the majority owner does not control and does not consolidate the limited liability corporation.

11.3.2.2**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.

⁷⁷ Comments by Jeffrey Nick, SEC Professional Accounting Fellow, at the 2020 AICPA National Conference on Current SEC and PCAOB Developments.

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.

11.3.3**Timing of assessment of control for a voting interest entity****Excerpt from Accounting Standards Codification**

Consolidation – Overall

Recognition***The Effect of Noncontrolling Rights on Consolidation*****810-10-25-5**

...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.

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 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 section 12 for further discussion). The reporting entity 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.

11.4 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. See ASC 810-10-55-206 for a decision tree that illustrates the determination of whether a physician practice management entity consolidates a physician practice and ASC 810-10-55-207 through 209 for additional background on physician practice management fact patterns.

12 Reconsideration events

12.1 Reconsideration of whether an entity is a VIE

Excerpt from Accounting Standards Codification

Consolidation – Overall

Subsequent Measurement – Variable Interest Entities

810-10-35-4

A legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its **expected losses** that reduce the equity investment. The initial determination of whether a legal entity is a VIE shall be reconsidered if any of the following occur:

- a. The legal entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity's equity investment at risk.
- b. The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity.
- c. The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses.
- d. The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses.
- e. Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

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.

12.1.1 Common VIE reconsideration events

Common events that require reconsideration of whether an entity is a VIE include the following when they represent a substantive change in the design 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
- ▶ Signing of collaboration agreement or licensing of technology
- ▶ Revisions to significant service contracts
- ▶ Leases of significant new assets
- ▶ Revisions to existing lease terms
- ▶ Significant acquisitions of new assets
- ▶ Bankruptcy or liquidation
- ▶ Acquisition or sale of interests that constitute a change of control
- ▶ Termination of or entering into new 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 section 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 12-1: 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. 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 12.1.1.4).

Example 2

Leaseco modifies the term of a lease.

Analysis

The variable interest holders should evaluate whether a lease modification represents a reconsideration event.

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.

Question 12.1 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 US 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 upon the reconsideration event should be used to evaluate the sufficiency of the equity investment at risk.

Question 12.2 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 obligations after 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 31 March 2015 (see section 13.6).

12.1.1.1 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.

12.1.1.2 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.

12.1.1.3 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 12-2: 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 section 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 Leaseco'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 12.1.1.4).

12.1.1.4**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 12-3: 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 classified as 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.

12.1.1.5**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 12-4: 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.

12.1.1.6**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.

12.1.1.7 **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.

12.1.1.8 **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.

12.1.1.9 **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.

12.1.1.10 **Change in power due to an event (e.g., loan default)**

The Variable Interest Model requires a reporting entity to reevaluate whether an entity is a VIE when 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. A change in power could occur when an agreement states that upon a specified significant event 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.

12.1.1.11

Contract modifications due to LIBOR transition (updated June 2023)**Excerpt from Accounting Standards Codification**

Reference Rate Reform – Overall

*Scope and Scope Exceptions – General***848-10-15-3**

The guidance in this Topic, if elected by an entity, shall apply to contracts or other transactions that reference the London Interbank Offered Rate (LIBOR) or a reference rate that is expected to be discontinued as a result of reference rate reform.

Pending Content:

Transition Date: (P) January 1, 2025; (N) January 1, 2025 | **Transition Guidance:** 848-10-65-1

Paragraph superseded by Accounting Standards Update No. 2020-04.

Reference Rate Reform – Contract Modifications

*Scope and Scope Exceptions – General***848-20-15-2**

The guidance in this Subtopic, if elected, shall apply to contract modifications if the terms that are modified directly replace, or have the potential to replace, a reference rate within the scope of paragraph 848-10-15-3 with another interest rate index. If other terms are contemporaneously modified in a manner that changes, or has the potential to change, the amount or timing of contractual cash flows, the guidance in this Subtopic shall apply only if those modifications are related to the replacement of a reference rate. For example, the addition of contractual fallback terms or the amendment of existing contractual fallback terms related to the replacement of a reference rate that are contingent on one or more events occurring has the potential to change the amount or timing of contractual cash flows and the entity potentially would be eligible to apply the guidance in this Subtopic.

Pending Content:

Transition Date: (P) January 1, 2025; (N) January 1, 2025 | **Transition Guidance:** 848-10-65-2

848-20-15-2

The guidance in this Subtopic, if elected, shall apply to contracts that meet the scope of paragraph 848-10-15-3 if either or both of the following occur:

- a. The terms that are modified directly replace, or have the potential to replace, a reference rate within the scope of paragraph 848-10-15-3 with another interest rate index. If other terms are contemporaneously modified in a manner that changes, or has the potential to change, the amount or timing of contractual cash flows, the guidance in this Subtopic shall apply only if those modifications are related to the replacement of a reference rate. For example, the addition of contractual fallback terms or the amendment of existing contractual fallback terms related to the replacement of a reference rate that are contingent on one or more events occurring has the potential to change the amount or timing of contractual cash flows and the entity potentially would be eligible to apply the guidance in this Subtopic.
- b. The interest rate used for margining, discounting, or contract price alignment is modified as a result of reference rate reform.

Pending Content:

Transition Date: (P) January 1, 2025; (N) January 1, 2025 | **Transition Guidance:** 848-10-65-1

Paragraph superseded by Accounting Standards Update No. 2020-04.

848-20-15-3

The guidance in this Subtopic shall not apply if a contract modification is made to a term that changes, or has the potential to change, the amount or timing of contractual cash flows and is unrelated to the replacement of a reference rate. That is, this Subtopic shall not apply if contract modifications are made contemporaneously to terms that are unrelated to the replacement of a reference rate.

Pending Content:

Transition Date: (P) January 1, 2025; (N) January 1, 2025 | **Transition Guidance:** 848-10-65-2

848-20-15-3

Other than a modification of the interest rate used for margining, discounting, or contract price alignment in accordance with paragraph 848-20-15-2(b), for contracts that meet the scope of paragraph 848-10-15-3, the guidance in this Subtopic shall not apply if a contract modification is made to a term that changes, or has the potential to change, the amount or timing of contractual cash flows and is unrelated to the replacement of a reference rate. That is, this Subtopic shall not apply if contract modifications are made contemporaneously to terms that are unrelated to the replacement of a reference rate.

Pending Content:

Transition Date: (P) January 1, 2025; (N) January 1, 2025 | **Transition Guidance:** 848-10-65-1

Paragraph superseded by Accounting Standards Update No. 2020-04.

*Subsequent Measurement – General***848-20-35-4**

If a contract is not within the scope of the Topics referenced in paragraph 848-20-35-3, an entity shall have the option to account for and present a modification that meets the scope of paragraphs 848-20-15-2 through 15-3 as an event that does not require contract remeasurement at the modification date or reassessment of a previous accounting determination required under the relevant Topic or Industry Subtopic. Paragraph 848-20-55-2 includes examples that illustrate the application of that guidance.

Pending Content:

Transition Date: (P) January 1, 2025; (N) January 1, 2025 | **Transition Guidance:** 848-10-65-1

Paragraph superseded by Accounting Standards Update No. 2020-04.

*Implementation Guidance and Illustrations***848-20-55-2**

The following table illustrates the potential outcomes of applying the guidance in paragraph 848-20-35-4 to contract modifications that meet the scope of paragraphs 848-20-15-2 through 15-3 but are not within the scope of the Topics listed in paragraph 848-20-35-3. This table is not intended to be all-inclusive of the potential application of paragraph 848-20-35-4 ...

Contract or Instrument Modified as a Result of Reference Rate Reform	Potential Outcome of Applying Paragraph 848-20-35-4
A contract with a counterparty entity that is within the scope of the Variable Interest Entities (VIE) Subsections in accordance with Topic 810 on consolidation	An entity should not reconsider the determination of the counterparty entity's VIE status in accordance with paragraph 810-10-35-4. The counterparty entity's VIE status should remain unchanged from the VIE status determined before the modification.

Pending Content:

Transition Date: (P) January 1, 2025; (N) January 1, 2025 | **Transition Guidance:** 848-10-65-1

Paragraph superseded by Accounting Standards Update No. 2020-04.

ASC 848 provides temporary optional expedients and exceptions to the guidance in US GAAP on contract modifications and hedge accounting to ease the financial reporting burdens related to the expected market transition from LIBOR and other interbank offered rates to alternative reference rates, such as the Secured Overnight Financing Rate (SOFR). The guidance is effective upon issuance and reporting entities generally can apply it through 31 December 2024.

When a reporting entity modifies a contract with a counterparty that is in the scope of the Variable Interest Model and references LIBOR or another reference interest rate that is expected to be discontinued due to reference rate reform (i.e., the contract references an eligible reference rate in the scope of ASC 848), the reporting entity does not reconsider whether the counterparty is a VIE if the modified contract meets one of the following criteria:

- ▶ The contract references LIBOR or another rate that is expected to be discontinued due to reference rate reform.
- ▶ The modified terms directly replace or have the potential to replace an eligible reference rate due to reference rate reform, and any contemporaneous changes to other terms (i.e., those that don't directly replace or have the potential to replace a reference rate) that change or have the potential to change the amount or timing of contractual cash flows are related to the replacement of a reference rate.
- ▶ The interest rate used for discounting, margining or contract price alignment is modified as a result of reference rate reform.

For contracts that do not reference an eligible reference rate, the contract modification relief can only be applied when the rate used for discounting, margining or contract price alignment is changed as a result of reference rate reform.

If a reporting entity elects to apply the relief, it would need to apply it consistently for all eligible modified contracts accounted for under a particular Codification topic (e.g., ASC 810) or industry subtopic. See our Technical Line publication, [*A closer look at the FASB's accounting relief related to reference rate reform*](#), for more guidance on the relief.

For contract modifications that do not meet the criteria for relief, that occur after 31 December 2024 or for which relief is not elected, the reporting entity would evaluate whether the contract modification is a reconsideration event and, if so, whether it changes the determination of whether the entity is a VIE.

12.2 Continuous assessment 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 indicate there might be 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 section 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
- ▶ Changes in related party or de facto agency relationships

12.2.1

Changes to the primary beneficiary when a contract is modified as a result of reference rate reform (updated June 2023)

ASC 848 provides temporary optional expedients and exceptions to the guidance in US GAAP on contract modifications and hedge accounting to ease the financial reporting burdens related to the expected market transition from LIBOR and other interbank offered rates to alternative reference interest rates, such as the SOFR. The guidance is effective upon issuance, and reporting entities generally can apply it prospectively through 31 December 2024.

When the criteria from ASC 848 for relief from modification accounting are met (see section 12.1.1.11), and this relief is elected, a reporting entity is relieved from assessing whether the contract modification changes the primary beneficiary.

See our Technical Line publication, [*A closer look at the FASB's accounting relief related to reference rate reform*](#), for more guidance on the relief.

For contract modifications that do not meet the criteria from ASC 848 (see section 12.1.1.11), that occur after 31 December 2024 or for which relief is not elected, the reporting entity would assess whether the modification changes the primary beneficiary, based on the facts and circumstances.

13 Initial measurement and consolidation of a VIE

13.1 Introduction

Paragraphs 810-10-30-1 through 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 (see section 13.2), and if not, whether the VIE is a business (see section 13.3) or a group of assets (see section 13.4). Specific guidance is provided for collateralized financing entities (see section 13.5).

See section 14.1.2.1 for income tax considerations related to gaining control of a subsidiary, including a VIE.

13.2 Primary beneficiary and VIE are under common control

Excerpt from Accounting Standards Codification

Consolidation – Overall

Initial Measurement – Variable Interest Entities

810-10-30-1

If the **primary beneficiary** of a **variable interest entity** (VIE) and the VIE are under common control, the primary beneficiary shall initially measure the assets, liabilities, and **noncontrolling interests** of the VIE at amounts at which they are carried in the accounts of the reporting entity that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles [GAAP]).

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*).

13.3 Primary beneficiary of a VIE that is a business

Excerpt from Accounting Standards Codification

Consolidation – Overall

Initial Measurement – Variable Interest Entities

810-10-30-2

The initial consolidation of a VIE that is a **business** is a **business combination** and shall be accounted for in accordance with the provisions in Topic 805.

When the primary beneficiary and the VIE are not under common control, 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. See our FRD, *Business combinations*, for additional discussion of ASC 805. Any goodwill recognized in the initial consolidation of a VIE should be evaluated for impairment pursuant to the provisions of ASC 350.

13.4

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.

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. Instead, when the primary beneficiary and the VIE are not under common control, 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.

Excerpt from Accounting Standards Codification

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. Transaction costs should be expensed. 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. A gain or loss is recognized for the difference between the consideration transferred and the assets and liabilities recognized. See sections 3, 4 and A.1.1 of our FRD, ***Business combinations***, for guidance when the VIE does not meet the definition of a business.

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. 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. Such transactions should be accounted for consistently with transactions falling under the common control provisions of ASC 805-50-30-5. See Appendix C of our FRD, ***Business combinations***, for more guidance on the accounting for common control transactions.

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."

13.4.1 **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 7.

13.4.2 **Subsequent accounting for in-process research and development (IPR&D) and contingent consideration**

While ASC 810 provides guidance on initial recognition and measurement when a primary beneficiary consolidates a VIE that is not a business, it does not provide guidance on the subsequent accounting for IPR&D intangible assets and contingent consideration arrangements. The lack of guidance has led to diversity in practice.

For example, for IPR&D initially recognized and measured at fair value pursuant to the guidance in ASC 810, a reporting entity may follow the subsequent accounting guidance for intangible assets acquired in a business combination in ASC 350. Alternatively, a reporting entity may conclude that, because the VIE is not a business, it should subsequently account for these IPR&D intangible assets under ASC 730. That is, IPR&D intangible assets with no alternative future use are recognized as an expense at the acquisition date.

See Appendix A and section A.1.1.1 in our FRD, ***Business combinations***, for guidance on subsequent accounting for IPR&D and contingent consideration when the VIE does not meet the definition of a business.

13.5 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).

13.5.1 Measurement alternative for consolidated collateralized financing entities

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.

To eliminate this potential measurement difference, the FASB provided 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.⁷⁸

There are certain scope requirements to qualify for the alternative and an exception that will allow entities to apply the measurement alternative to certain consolidated CFEs that would not otherwise meet the scope requirements.

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.

⁷⁸ Paragraph BC13 of ASU 2014-13.

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, a CFE is 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 820.⁷⁹

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

⁷⁹ Paragraph BC9 of ASU 2014-13.

- b. The sum of:
1. The fair value of any **beneficial interests** retained by the reporting entity (other than those that represent compensation for services)
 2. The reporting entity's carrying value of any beneficial interests that represent compensation for services.

The fair value of the financial assets in (a)(1) should include the carrying values of any financial assets that are incidental to the operations of the collateralized financing entity because the financial assets' carrying values approximate their fair values.

810-10-30-13

If the fair value of the financial liabilities of the collateralized financing entity is more observable, those financial liabilities shall be measured at fair value. The financial assets shall be measured in the initial consolidation as the difference between the following two amounts:

- a. The sum of:
1. The fair value of the financial liabilities (other than the beneficial interests retained by the reporting entity)
 2. The fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)
 3. The reporting entity's carrying value of any beneficial interests that represent compensation for services
- b. The carrying value of any nonfinancial assets held temporarily.

The fair value of the financial liabilities in (a)(1) should include the carrying values of any financial liabilities that are incidental to the operations of the collateralized financing entity because the financial liabilities' carrying values approximate their fair values.

810-10-30-14

The amount resulting from paragraph 810-10-30-12 or paragraph 810-10-30-13 shall be allocated to the less observable of the financial assets and financial liabilities (other than the beneficial interests retained by the reporting entity), as applicable, using a reasonable and consistent methodology.

810-10-30-15

The carrying value of the beneficial interests that represent compensation for services (for example, rights to receive management fees or servicing fees) and the carrying value of any nonfinancial assets held temporarily by the **collateralized financing entity** shall be measured in accordance with other applicable Topics.

810-10-30-16

If a reporting entity does not elect to apply the measurement alternative to a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, the reporting entity shall measure the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity using the requirements of Topic 820 on fair value measurement. If Topic 820 is applied, any initial difference in the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

Under the guidance, 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 manner in which the guidance 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.

A reporting entity that does not elect the alternative recognizes any difference between the fair values of a consolidated CFE's financial assets and financial liabilities in earnings and attributes these differences to the reporting entity (i.e., controlling interest holder) in the consolidated statement of income (loss).

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. See section 23.2.9 for further information on disclosures.

13.6 SEC reporting considerations (updated June 2023)

Rule 3-05 of Regulation S-X describes the SEC's requirements for registrants to provide financial statements of a significant business acquired or to be acquired, including the acquisition of a significant interest in a business accounted for under the equity method. Rule 3-14 of Regulation S-X describes the requirements for audited statements of real estate operations acquired or to be acquired. Article 11 of Regulation S-X describes the SEC's requirements for registrants to provide pro forma financial information when events occur, or conditions exist for which disclosure would be material for investors (e.g., acquisition of a significant business or real estate operations, disposition of a significant business). (See our publication, *Pro forma financial information: a guide for applying Article 11 of Regulation S-X*, for more guidance.) These requirements generally apply to registration statements, certain proxy statements and Form 8-K filings.

In addition, Item 2.03(b) of Form 8-K requires a registrant to report if it becomes directly or contingently liable for an obligation that is material to the registrant arising out of an off-balance sheet arrangement, including any obligation arising out of a material variable interest.

These SEC reporting requirements should also be considered upon initial consolidation or deconsolidation of a VIE (i.e., the requirements are not limited to voting interest entities).⁸⁰

With respect to the adoption of an ASU, the SEC staff shared the views below regarding reporting implications. While the following views were expressed specific to the adoption of ASU 2015-02, we have applied the same views with respect to the adoption of other ASUs that affect the initial consolidation or deconsolidation of an entity (e.g., ASU 2018-17).

Non-authoritative literature

Center for Audit Quality (CAQ) SEC Regulations Committee – Joint meeting with SEC Staff

March 2015

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...

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 – 9 April 2010](#).

⁸⁰ See the Center for Audit Quality SEC Regulations Committee meeting highlights on [22 September 2009](#) and [31 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.

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 3-14.⁸¹ This was reaffirmed when the SEC staff discussed the adoption of ASU 2015-02 at the SEC Regulations Committee on 31 March 2015 (see above excerpt from the meeting highlights). As part of the adoption of ASU 2018-17, we believed the SEC staff's views with respect to the application of Rule 3-05 and Rule 3-14 was also consistent with their prior views with respect to FAS 167 and ASU 2015-02 and would not trigger a requirement to report under Rule 3-05 or Rule 3-14.

13.7 Pre-existing hedge relationships under ASC 815

When a reporting entity is required to consolidate or deconsolidate an entity pursuant to ASC 810, 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 the Variable Interest Model (even after the initial adoption of FIN 46 and FIN 46(R) and subsequent ASUs) should not result in the immediate recognition of previously deferred derivative gains and losses if a surrogate (i.e., substitute) hedged item can be identified. See section 4.7 of our FRD, *Derivatives and hedging*, for more information.

13.8 Continuation of leveraged lease accounting by an equity investor in a deconsolidated lessor trust

It is common for a financial institution to establish a trust in which it is the sole equity investor. The trust then leases an asset to a lessee in a lease that qualifies for leveraged lease accounting. Upon the issuance of FIN 46 and creation of the Variable Interest Model, questions arose as to whether the equity investor (i.e., financial institution) should deconsolidate the trust, in which case it could no longer apply leveraged lease accounting.

⁸¹ The SEC staff shared this view with the Center for Audit Quality SEC Regulations Committee ([CAQ Alert #2010-20 – 9 April 2010](#)).

Based on our discussions with the FASB staff when FIN 46 was issued, 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 applied leveraged lease accounting pursuant to ASC 840 before deconsolidation, that accounting treatment should continue to be followed.

ASC 842 eliminates leveraged lease accounting for new leases entered into on or after its effective date, and existing leveraged leases modified after its effective date. See section 10.1 of our FRD, **Lease accounting – Accounting Standards Codification 842, Leases**, for additional guidance on leveraged leases. We believe that if the equity investor applied leveraged lease accounting that is grandfathered under ASC 842-50 it should continue applying that accounting treatment.

14 Consolidated financial statements

14.1 Introduction

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 of 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.

An entity may acquire a controlling financial interest in a subsidiary through a single investment or through multiple steps over time. See section 13 when control is obtained of a VIE. The rest of section 14.1 provides guidance on the initial measurement of an entity that is not a VIE.

A parent generally follows the same consolidation principles for voting interest entities and VIEs. These steps include:

- ▶ Consolidating the subsidiary's assets, liabilities, income and expenses
- ▶ Attributing net income or loss and other comprehensive income or loss to any noncontrolling interests (see sections 15 and 16)
- ▶ Eliminating intra-entity transactions (see section 17), although the elimination entries may differ
- ▶ Translating subsidiary financial statements under ASC 830 (see our FRD, *Foreign currency matters*)
- ▶ Recognizing deferred taxes on outside basis differences (see our FRD, *Income taxes*)

14.1.1 Acquisition through a single investment

ASC 805 provides guidance when an acquirer obtains control of a business through a single investment, often referred to as a "single-step acquisition." Single-step acquisitions may be the most familiar form of business combination. ASC 805 requires an acquirer to recognize the assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree, all generally measured at their fair values as of the acquisition date. These concepts are discussed further in our FRD, *Business combinations*. The examples in section 18 include an example of the accounting for a single-step acquisition (see section 18.6, Illustration 18-12). Illustration 14-1 summarizes these concepts.

14.1.2 Acquisition through multiple investments

When an acquirer obtains control of a business through a series of investments, the acquisition is often called a "step acquisition" or, in ASC 805, a "business combination achieved in stages." Under ASC 805, if the acquirer holds a noncontrolling equity investment in the acquiree immediately before obtaining control, the acquirer should first remeasure that investment at fair value as of the acquisition date and recognize any remeasurement gain or loss in earnings. If before obtaining control an acquirer recognized amounts in other comprehensive income related to its equity investment, those amounts should be reclassified from other comprehensive income and included in the recognized remeasurement gain or loss as of the acquisition date. The acquirer then should apply ASC 805's business combination guidance, as discussed in our FRD, *Business combinations*.

After taking control of a target company, further acquisitions of ownership interests (i.e., acquisitions of noncontrolling ownership interests with no changes in control) are accounted for as transactions among shareholders within equity pursuant to ASC 810 (see section 18).

Illustration 14-1 summarizes these concepts.

Illustration 14-1: Summary of guidance applied for acquisitions of an interest in an entity	
Acquisition of an interest in an entity but control is not obtained	Apply other GAAP (e.g., ASC 321, ASC 323).
Acquisition of an additional interest in an entity that provides control	<p>If the entity is a business, first, remeasure the previously held interest (i.e., the interest held before obtaining control, if any) at fair value, recognizing any gain or loss in earnings. Next, measure and consolidate (generally at fair value) the net assets acquired and any noncontrolling interests, in accordance with ASC 805. Consider the accounting for any currency translation adjustment related to any previously held interests and the accounting for income taxes. (See our FRD, <i>Business combinations</i>, for further interpretive guidance).</p> <p>See Appendix A in our FRD, <i>Business combinations</i>, for guidance when the entity does not meet the definition of a business (i.e., an asset acquisition).</p> <p>See Appendix C in our FRD, <i>Business combinations</i>, for guidance when the transacting parties are under common control.</p> <p>If the entity is a VIE, for both businesses and asset acquisitions and transactions under common control, see section 13 of this FRD.</p>
Acquisition of an additional interest in an entity, after control has already been obtained	Reduce the carrying amount of the noncontrolling interest. Recognize any difference between the consideration paid and the reduction to the noncontrolling interest in equity attributable to the controlling interest. (See section 18.3.1 for further guidance).

14.1.2.1 Income tax considerations related to gaining control of a subsidiary

See sections 11, 13 and 14 of our FRD, *Income taxes*, for discussion of income tax considerations related to business combinations, asset acquisitions and obtaining control of foreign and domestic subsidiaries.

14.2 Undivided interests and proportionate consolidation

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

810-10-45-14

If the investor-venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability, the provisions of paragraph 323-10-45-1 may not apply in some industries. For example, in certain industries the investor-venturer may account in its financial statements for its pro rata share of the assets, liabilities, revenues, and expenses of the venture. Specifically, a proportionate gross financial statement presentation is not appropriate for an investment in an unincorporated legal entity accounted for by the equity method of accounting unless the investee is in either the construction industry (see paragraph 910-810-45-1) or an extractive industry (see paragraphs 930-810-45-1 and 932-810-45-1). An entity is in an extractive industry only if its activities are limited to the extraction of mineral resources (such as oil and gas exploration and production) and not if its activities involve related activities such as refining, marketing, or transporting extracted mineral resources.

Real Estate – General – Investments – Equity Method and Joint Ventures

Recognition

970-323-25-12

If real property owned by undivided interests is subject to **joint control** by the owners, the investor-venturers shall not present their investments by accounting for their pro rata share of the assets, liabilities, revenues, and expenses of the ventures. Most real estate ventures with ownership in the form of undivided interests are subject to some level of joint control. Accordingly, such investments shall be presented in the same manner as investments in noncontrolled partnerships.

Glossary

970-323-20

Joint control

Occurs if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners.

Undivided interest

An ownership arrangement in which two or more parties jointly own property, and title is held individually to the extent of each party's interest.

Real Estate – General – Consolidation

Other Presentation Matters

970-810-45-1

An investment in real property may be presented by recording the undivided interest in the assets, liabilities, revenue, and expenses of the venture if all of the following conditions are met:

- a. The real property is owned by **undivided interests**.
- b. The approval of two or more of the owners is not required for decisions regarding the financing, development, sale, or operations of real estate owned.
- c. Each investor is entitled to only its pro rata share of income.
- d. Each investor is responsible to pay only its pro rata share of expenses.
- e. Each investor is severally liable only for indebtedness it incurs in connection with its interest in the property.

Proportionate consolidation is permitted only for the following:

- ▶ Investments in unincorporated legal entities (e.g., partnerships) in either the extractive⁸² or construction⁸³ industries that otherwise would be accounted for under the equity method of accounting (i.e., a controlling financial interest does not exist).
- ▶ Ownership of an undivided interest in an asset when each owner is entitled only to its pro rata share of income and expenses and is proportionately liable for its share of each liability. However, real estate entities subject to ASC 970-323 that own an undivided interest in real property that is under joint control (as defined in US GAAP) must use the equity method of accounting.

Under proportionate consolidation, the investor presents its proportionate share of the investee's revenues and expenses in each major revenue and expense caption of the investor's income statement. Also, the investor may present⁸⁴ its proportionate share of the investee's assets and liabilities separately in each major asset and liability caption of the investor's balance sheet. In the construction industry, a combination of a one-line presentation and proportionate consolidation also may be used. That is, some entities in the construction industry may present their investment on the balance sheet using a one-line presentation and present their proportionate share of the investee's revenues and expenses using proportionate consolidation. An investor is not precluded from proportionately consolidating an investment that would otherwise qualify for such treatment simply because another party controls and consolidates the investment in accordance with ASC 810.

An investor applying proportionate consolidation needs to apply typical consolidation procedure. For example, it would need to evaluate intercompany balances and transactions to ensure they are properly eliminated, in the same manner that it would for consolidated entities.

⁸² ASC 810-10-45-14 states: "An entity is in an extractive industry only if its activities are limited to the extraction of mineral resources (such as oil and gas exploration and production) and not if its activities involve related activities such as refining, marketing, or transporting extracted mineral resources."

⁸³ To determine which entities are in the construction industry, ASC 910-10-15-3 through 4 describe certain characteristics that are common to entities in the industry. "The most basic characteristic is that work is performed under contractual arrangements with customers. A contractor, regardless of the type of construction activity or the type of contractor, typically enters into an agreement with a customer to build or to make improvements on a tangible property to the customer's specification. The contract with the customer specifies the work to be performed, specifies the basis of determining the amount and terms of payment of the contract price and generally requires total performance before the contractor's obligation is discharged. Unlike the work of many manufacturers, the construction activities of a contractor are usually performed at job sites owned by customers rather than at a central place of business, and each contract usually involves the production of a unique property rather than repetitive production of identical products. Other characteristics common to contractors and significant to accountants and users of financial statements include the following:

- (a) A contractor normally obtains the contracts that generate revenue or sales by bidding or negotiating for specific projects.
- (b) A contractor bids for or negotiates the initial contract price based on an estimate of the cost to complete the project and the desired profit margin, although the initial price may be changed or renegotiated.
- (c) A contractor may be exposed to significant risks in the performance of a contract, particularly a fixed-price contract.
- (d) Customers (usually referred to as owners) frequently require a contractor to post a performance and a payment bond as protection against the contractor's failure to meet performance and payment requirements.
- (e) The costs and revenues of a contractor are typically accumulated and accounted for by individual contracts or contract commitments extending beyond one accounting period, which complicates the management, accounting, and auditing processes.
- (f) The nature of a contractor's risk exposure varies with the type of contract. The several types of contracts used in the construction industry are described in paragraphs 605-35-15-2 through 15-5. The four basic types of contracts used based on their pricing arrangements are fixed-price or lump-sum contracts, unit-price contracts, cost-type contracts, and time-and-materials contracts."

⁸⁴ EITF 00-1 Issue, paragraph 2 states: "However, there is a longstanding practice in the construction industry and in the extractive industries of investors displaying investments in separate legal entities (that is, they do not own an undivided interest as described in paragraph 1) accounted for using the equity method of accounting on a proportionate gross basis. Under that practice, the investor presents its proportionate share of the investee's revenues and expenses in each major revenue and expense caption of the investor's income statement and **may** also present its proportionate share of the investee's assets and liabilities separately in each major asset and liability caption of the investor's balance sheet." [Emphasis added]. Although this paragraph was not codified, we believe it remains relevant for entities operating in these industries.

When an investee does not qualify to be proportionately consolidated, we have observed that the SEC staff has objected to presenting pro forma financial statements prepared using proportionate consolidation as a non-GAAP disclosure. See section 3.4.2 of our FRD, *Equity method investments and joint ventures*, for additional guidance.

14.3 Differing fiscal year-ends between parent and subsidiary

Excerpt from Accounting Standards Codification

Consolidation – Overall

Scope and Scope Exceptions

810-10-15-11

A difference in fiscal periods of a parent and a subsidiary does not justify the exclusion of the subsidiary from consolidation.

Other Presentation Matters

Differing Fiscal Year-Ends Between Parent and Subsidiary

810-10-45-12

It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, financial statements for a period that corresponds with or closely approaches the fiscal period of the parent. However, if the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's financial statements for its fiscal period; if this is done, recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations.

810-10-45-13

A parent or an investor should report a change to (or the elimination of) a previously existing difference between the parent's reporting period and the reporting period of a consolidated entity or between the reporting period of an investor and the reporting period of an equity method investee in the parent's or investor's consolidated financial statements as a change in accounting principle in accordance with the provisions of Topic 250. While that Topic generally requires voluntary changes in accounting principles to be reported retrospectively, retrospective application is not required if it is impracticable to apply the effects of the change pursuant to paragraphs 250-10-45-9 through 45-10. The change or elimination of a lag period represents a change in accounting principle as defined in Topic 250. The scope of this paragraph applies to all entities that change (or eliminate) a previously existing difference between the reporting periods of a parent and a consolidated entity or an investor and an equity method investee. That change may include a change in or the elimination of the previously existing difference (lag period) due to the parent's or investor's ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the parent or investor. This paragraph does not apply in situations in which a parent entity or an investor changes its fiscal year-end.

Disclosure

810-10-50-2

An entity should make the disclosures required pursuant to Topic 250. This paragraph applies to all entities that change (or eliminate) a previously existing difference between the reporting periods of a parent and a consolidated entity or an investor and an equity method investee. This paragraph does not apply in situations in which a parent entity or an investor changes its fiscal year-end.

A parent must consolidate a controlled subsidiary, even if it has a different fiscal year-end than the parent. If a subsidiary has a different fiscal year end, the parent can use the subsidiary's financial statements for consolidation purposes, as long as the difference in fiscal year-ends is not more than about three months. In these circumstances, the parent should disclose or recognize the effect of intervening events that, if recognized, would materially affect the consolidated financial position or results of operations.

When a parent uses a subsidiary's financial statements that have a different fiscal year end for consolidation, the parent will need to carefully consider how it applies consolidation procedure. For example, intercompany transactions should be evaluated to ensure they are properly eliminated and that any assets (e.g., cash) transferred between the parent and the subsidiary during the intervening period are not double-counted in consolidation. Separately, the carrying amount of the subsidiary's assets and liabilities would be reflected in the consolidated financial statements as of the period end of the subsidiary's fiscal year end and not as of the parent's fiscal year end. This includes situations in which certain subsidiary balances are reported at fair value.

When a parent changes a subsidiary's fiscal year-end, the parent would report this as a change in accounting principle in accordance with the provisions of ASC 250.⁸⁵ Under ASC 250's guidance, the parent is required to assess whether a change is preferable and, if so, report the change in accordance with ASC 250. ASC 250 requires retrospective application to prior-period financial statements of voluntary changes in accounting principle, unless it is impracticable to apply the effects of the change retrospectively. See section 3 of our FRD, *Accounting changes and error corrections*, for guidance on a voluntary change in accounting principle.

14.4 Using subsidiary financial statements prepared as of an earlier period end for consolidation procedures in circumstances when the subsidiary has the same fiscal year end as the parent

Excerpt from Accounting Standards Codification

Investments – Equity Method and Joint Ventures – Overall

Subsequent Measurement

323-10-35-6

If financial statements of an investee are not sufficiently timely for an investor to apply the equity method currently, the investor ordinarily shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period.

ASC 810 does not specifically address whether it is acceptable for a parent that has the same fiscal year end as a subsidiary to use subsidiary financial statements that are prepared on a lag for consolidation purposes. Depending on the facts and circumstances, we believe it may be acceptable to do so.

For example, both a parent and a subsidiary may have a year end of 31 December; however, the parent may not receive the subsidiary's 31 December financial statements until mid-March. As a result, it might not be practical for the parent to use the subsidiary's 31 December financial statements.

We believe the decision to apply consolidation procedure on a lag is a policy election that should be applied consistently from period to period and subsidiary by subsidiary. We believe a parent could have one subsidiary that is on a lag and another that is not. We believe that a parent should apply the same maximum difference for consolidated subsidiaries with different fiscal year ends (i.e., a lag of no more than about three months). Intervening events that materially affect the financial position or results of operations should be disclosed.

⁸⁵ This guidance does not apply, however, in situations in which a parent entity changes its own fiscal year-end.

When a parent uses a subsidiary's financial statements on a lag for consolidation, the parent will need to carefully consider its consolidation procedure. For example, intercompany transactions should be evaluated to ensure they are properly eliminated and that any assets (e.g., cash) transferred between the parent and the subsidiary during the intervening period are not double-counted in consolidation. Separately, the carrying amount of the subsidiary's assets and liabilities would be reflected in the consolidated financial statements as of the period end of the subsidiary's most recently available financial statements and not as of the consolidated entity's fiscal year end. This includes situations in which certain subsidiary balances are reported at fair value.

We believe a parent's decision to change or eliminate an existing lag between the parent and the subsidiary is considered a change in accounting principle in accordance with ASC 250. Under that guidance, the parent is required to assess whether the change is preferable and, if so, report the change in accordance with ASC 250. ASC 250 requires retrospective application to prior-period financial statements of voluntary changes in accounting principle, unless it is impracticable to apply the effects of the change retrospectively.

14.4.1 Reporting lag in the period of obtaining control

A parent is required to apply its lag policy to a subsidiary consistently from period to period. When accounting for a subsidiary on a lag, we believe the parent cannot include the subsidiary's earnings for the period before the parent obtained control of the subsidiary. The subsidiary's earnings before the parent obtained control of the subsidiary have already been reflected in the fair value of the subsidiary at initial measurement.

Illustration 14-2: Reporting lag in the period of obtaining control

A parent obtains control of a subsidiary that is a business on 1 January 20X1 and elects to consolidate the subsidiary's earnings on a one-quarter lag. The subsidiary's earnings for the quarters ended 31 December 20X0 and 31 March 20X1 are \$10 and \$15, respectively.

Analysis

The parent would record the business combination and consolidate the subsidiary on 1 January 20X1.

The parent would present the subsidiary's \$15 earnings (for the subsidiary's quarter ended 31 March 20X1) in the parent's consolidated financial statements for the quarter ended 30 June 20X1.

The parent would not present any earnings for the subsidiary in the parent's quarter ended 31 March 20X1 (while the parent builds up the reporting lag). The subsidiary's \$10 earnings for the subsidiary's quarter ended 31 December 20X0 are effectively captured in the initial measurement on 1 January 20X1.

See our FRD, *Business combinations*, for more guidance on the initial measurement of a business upon gaining control. See section 13.1 for guidance on the initial measurement of a VIE.

14.4.2 Reporting lag in the period of losing control

When a parent loses control of a subsidiary that is accounted for on a lag, the parent presents earnings only up to the date of the subsidiary's most recently available financial statements. A parent recognizes a gain or loss on disposal in the period when control is lost (i.e., not on a lag).

Illustration 14-3: Reporting lag in the period of losing control

On 31 December 20X1, a parent sells and loses control of its subsidiary that is on a quarterly lag for \$100, when the carrying amount of the subsidiary's net assets is \$60 in the consolidated financial statements. The subsidiary's earnings in its standalone financial statements for the quarters ended 30 September 20X1 and 31 December 20X1 are \$10 and \$15, respectively.

Analysis

We believe the parent would present the subsidiary's \$10 earnings (for the subsidiary's quarter ended 30 September 20X1) in its consolidated financial statements for the quarter ended 31 December 20X1. The parent should recognize a gain of \$40 (\$100 selling price - \$60 carrying amount) on 31 December 20X1 upon disposal.

The parent would not present any earnings for that subsidiary in the parent's consolidated financial statements for the quarter ended 31 March 20X2. The subsidiary's \$15 earnings for the quarter ended 31 December 20X1 are effectively captured in the selling price of the subsidiary (if any) and the gain or loss on disposal.

See section 19 for more guidance on the accounting for the loss of control of a business or subsidiary that is in the scope of ASC 810.

14.5 Subsidiary's accounting basis is not US GAAP

A subsidiary may follow accounting principles that differ from US GAAP (e.g., IFRS) for separate reporting purposes. When this is the case, the parent must adjust the subsidiary's financial statements to US GAAP in consolidation. The consolidated financial statements must be prepared in accordance with the authoritative principles and standards in the Accounting Standards Codification in order for the parent to assert they are presented in conformity with GAAP in the United States. SEC registrants also must apply the rules and interpretive releases of the SEC, which are additional sources of authoritative GAAP for those entities.

14.6 Differing accounting policies between parent and subsidiary (updated August 2022)**Excerpt from Accounting Standards Codification***Consolidation – Overall**Recognition***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.

US GAAP does not require that a parent and its subsidiaries have the same accounting policies. Typically, a parent concludes that it is appropriate to conform its subsidiaries' accounting policies to those of the parent. However, when a subsidiary was recently acquired, is a public company, or has specialized industry accounting principles, there may be reasons for maintaining different accounting policies between the parent and its subsidiaries.

If the subsidiary's financial statements were prepared in accordance with US GAAP and the parent follows an acceptable alternative available in US GAAP for similar items in its financial statements, the financial statements of the subsidiary generally are not adjusted in consolidation. For example, if a subsidiary applies the first-in, first-out (FIFO) method for inventory accounting but the parent applies the last-in, last-out (LIFO) method, adjustments to conform the inventory policies are not required. However, a parent would still need to evaluate intercompany balances and transactions to ensure they are properly eliminated.

Question 14.1 In consolidated financial statements, are the parent and its consolidated subsidiaries required to use the same adoption date when adopting a new ASU?

Yes. The adoption of an ASU is a change in accounting principle and must be accounted for under the guidance in ASC 250-10-45-1 through 45-16. ASC 250-10-45-2 refers to the “reporting entity” when discussing a change in accounting principle. Further, ASC 250-10-45-11 states that once an accounting principle is adopted, it must be consistently applied in accounting for similar events and transactions. In consolidated financial statements, the reporting entity includes the parent and its subsidiaries; therefore, consistent application requires a parent and its subsidiaries to adopt an ASU concurrently.

However, in the standalone financial statements of a subsidiary, the subsidiary is not required to adopt an ASU concurrently with its parent nor is it required to apply the same transition method for adoption as its parent because the subsidiary is a separate reporting entity in that situation. That said, in practice, a parent and its subsidiary often use the same adoption date and transition method even when separate financial statements are issued.

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Other Presentation Matters

250-10-45-11

In the preparation of financial statements, once an accounting principle is adopted, it shall be used consistently in accounting for similar events and transactions.

Question 14.2 Can a parent that is a going concern consolidate a subsidiary's financial statements that are prepared under the liquidation basis of accounting?

No. Assuming the subsidiary is still controlled and consolidated, it would be inappropriate to consolidate the subsidiary's liquidation basis financial statements with the financial statements of the parent if the parent is a going concern. Rather, the subsidiary's financial statements would be prepared on a going-concern basis, and consideration would be given to whether the subsidiary should be presented as a discontinued operation or considered held for sale in the parent's consolidated financial statements.

See section 11.3 of this publication and section 3.9.13 of our FRD, *Bankruptcies, liquidations and quasi-reorganizations*, for guidance on determining whether a parent should continue to consolidate a subsidiary that is in liquidation, and see section 6.2 of that FRD for determining whether the subsidiary's standalone financial statements should be presented on the liquidation basis.

15 Nature and classification of a noncontrolling interest

15.1 Noncontrolling interests (updated August 2022)

Excerpt from Accounting Standards Codification

Consolidation – Overall

Glossary

810-10-20

Noncontrolling Interest

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

Other Presentation Matters

810-10-45-15

The ownership interests in the subsidiary that are held by owners other than the parent is a noncontrolling interest. The noncontrolling interest in a subsidiary is part of the equity of the consolidated group.

810-10-45-16

The noncontrolling interest shall be reported in the consolidated statement of financial position within equity (net assets), separately from the parent's equity (or net assets). That amount shall be clearly identified and labeled, for example, as noncontrolling interest in subsidiaries (see paragraph 810-10-55-4I). An entity with noncontrolling interests in more than one subsidiary may present those interests in aggregate in the consolidated financial statements. A **not-for-profit entity** shall report the effects of any donor-imposed restrictions, if any, in accordance with paragraph 958-810-45-1.

810-10-45-16A

Only either of the following can be a noncontrolling interest in the consolidated financial statements:

- a. A financial instrument (or an embedded feature) issued by a subsidiary that is classified as equity in the subsidiary's financial statements
- b. A financial instrument (or an embedded feature) issued by a parent or a subsidiary for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary, that is considered indexed to the entity's own stock in the consolidated financial statements of the parent and that is classified as equity.

810-10-45-17

A financial instrument issued by a subsidiary that is classified as a liability in the subsidiary's financial statements based on the guidance in other Subtopics is not a noncontrolling interest because it is not an ownership interest. For example, Topic 480 provides guidance for classifying certain financial instruments issued by a subsidiary.

810-10-45-17A

An equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable GAAP) within the scope of the guidance in paragraph 815-40-15-5C shall be presented as a component of noncontrolling interest in the consolidated financial statements whether the instrument was entered into by the parent or the subsidiary. However, if such an equity-classified instrument was entered into by the parent and expires unexercised, the carrying amount of the instrument shall be reclassified from the noncontrolling interest to the controlling interest.

ASC 810-10 states that a noncontrolling interest in an entity is any equity interest in a consolidated entity that is not attributable to the parent. ASC 810-10 requires the noncontrolling interest to be reported separately from the parent's equity. Net income or loss (including other comprehensive income or loss) is attributed to the controlling and noncontrolling interests for all subsidiaries, regardless of whether a subsidiary is a voting interest entity or a VIE.

When issuing ASC 810-10, the FASB concluded that a noncontrolling interest in an entity meets the definition of equity in CON 6, which defines equity (or net assets) as, "the residual interest in the assets of an entity that remains after deducting its liabilities." A noncontrolling interest represents a residual interest in the assets of a subsidiary in a consolidated group and is, therefore, consistent with the definition of equity in CON 6.⁸⁶

A noncontrolling interest is presented separately from the equity of the parent so that users of the consolidated financial statements can distinguish the parent's equity from the equity of the subsidiary held by owners other than the parent. See section 23.3.3 for guidance on the presentation of noncontrolling interests in the consolidated statement of financial position and Illustration 23-3 for an example.

To be classified as equity in the consolidated financial statements, the instrument issued by the subsidiary should be classified as equity by the subsidiary based on other authoritative literature. If the instrument is classified as a liability in the subsidiary's financial statements, it cannot be presented as a noncontrolling interest in the consolidated entity's financial statements because that instrument does not represent an ownership interest in the consolidated entity under US GAAP. For example, because mandatorily redeemable preferred shares issued by a subsidiary are classified as a liability in the subsidiary's financial statements according to ASC 480, the preferred shares would not be classified as a noncontrolling interest in the consolidated financial statements. See section 5.10 of our FRD, **Issuer's accounting for debt and equity financings**, for additional guidance on classifying an instrument as debt or equity.

An equity-classified instrument (including an embedded feature that is separately recorded in equity) in the scope of ASC 815-40-15-5C is presented as a component of the noncontrolling interest in the consolidated financial statements regardless of whether the instrument was entered into by the parent or the subsidiary. A vested, equity-classified share-based payment option award that is modified after the employee was terminated is an example of such an equity-classified instrument. However, if the award expires, the carrying amount is reclassified from noncontrolling interest to the controlling interest (i.e., the parent's equity). See section 18.5.1 for guidance on accounting for a stock option on subsidiary stock during the vesting period.

For guidance on profit interests, such as some carried interests, see section 5.2.8 of our FRD, **Share-based payment**.

⁸⁶ See paragraph B34 of FAS 160.

Excerpt from Accounting Standards Codification

Consolidation – Overall

Parent with a Less-than-Wholly-Owned Subsidiary

810-10-50-1A

A **parent** with one or more less-than-wholly-owned **subsidiaries** shall disclose all of the following for each reporting period:

- a. Separately, on the face of the consolidated financial statements, both of the following:
 1. The amounts of consolidated net income and consolidated comprehensive income
 2. The related amounts of each attributable to the parent and the **noncontrolling interest**.
- b. Either in the notes or on the face of the consolidated income statement, amounts attributable to the parent for any of the following, if reported in the consolidated financial statements:
 1. Income from continuing operations
 2. Discontinued operations
 3. Subparagraph superseded by Accounting Standards Update No. 2015-01.
- c. Either in the consolidated statement of changes in equity, if presented, or in the notes to consolidated financial statements, a reconciliation at the beginning and the end of the period of the carrying amount of total equity (net assets), equity (net assets) attributable to the parent, and equity (net assets) attributable to the noncontrolling interest. That reconciliation shall separately disclose all of the following:
 1. Net income
 2. Transactions with owners acting in their capacity as owners, showing separately contributions from and distributions to owners
 3. Each component of other comprehensive income.
- d. In notes to the consolidated financial statements, a separate schedule that shows the effects of any changes in a parent's ownership interest in a subsidiary on the equity attributable to the parent.

Example 2 (see paragraph 810-10-55-4G) illustrates the application of the guidance in this paragraph.

Consolidated net income and consolidated comprehensive income include the revenues, expenses, gains and losses attributable to both the parent and the noncontrolling interest. The amounts of consolidated net income and consolidated comprehensive income attributable to both the parent and the noncontrolling interest should be presented on the face of the financial statements. See section 23.3.1 for guidance on the presentation of noncontrolling interests in the consolidated statements of net income and comprehensive income and Illustration 23-3 for an example.

ASC 810 does not prescribe the presentation for the statement of cash flows. See section 23.3.4 for guidance on presenting noncontrolling interests in the consolidated statement of cash flows.

15.1.1 Noncontrolling interests in consolidated variable interest entities

ASC 810-10 requires an entity to present assets and liabilities of a consolidated VIE separately on the balance sheet when certain conditions exist. ASC 810 does not address the presentation of noncontrolling interests in a consolidated VIE. We believe an entity is permitted to present noncontrolling interests of a consolidated VIE separately from other noncontrolling interests in the equity section of the balance sheet as long as it makes an accounting policy choice and applies that choice to all consolidated VIEs. See section 23 for further guidance on the presentation requirements for consolidated VIEs.

Question 15.1 Should a primary beneficiary account for equity interests in a VIE that are held by its related parties as noncontrolling interests?

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.

15.1.2 Initial recognition and measurement of a noncontrolling interest

The initial recognition of a noncontrolling interest typically occurs in the following circumstances:

- ▶ A business combination or asset acquisition of a less-than-wholly-owned subsidiary (see section 4.6 and section A.2.4 of our FRD, *Business combinations*, for additional guidance, respectively)
- ▶ An initial consolidation of a VIE (see section 13), including in a common control transaction
- ▶ A parent's sale of shares of a wholly owned subsidiary, without losing control of the subsidiary (see section 18.3.2 and 18.4)
- ▶ A wholly owned subsidiary issues shares to parties that are not controlled by the parent, while the parent retains control of the subsidiary (see section 18.3.2 and 18.4)
- ▶ A common control transaction for a Voting Interest Entity (see section C.4.3 of our FRD, *Business combinations*, for additional guidance)

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

Procedures

810-10-45-2

The retained earnings or deficit of a **subsidiary** at the date of acquisition by the **parent** shall not be included in consolidated retained earnings.

When a parent initially consolidates a subsidiary, the retained earnings or deficit of the subsidiary relating to periods before the parent obtained control is not included in the parent's consolidated retained earnings at the date of acquisition.

15.2 Equity contracts issued on the stock of a subsidiary (e.g., redeemable noncontrolling interests)

An acquirer that acquires a controlling financial interest in an acquiree but less than 100% of the equity may want the right to obtain the noncontrolling interest at a later date. The acquirer could execute a call option (a right) or a forward contract (an unconditional obligation) on the noncontrolling interest with the seller that would give the acquirer flexibility on when to acquire the noncontrolling interest and how to finance it. The seller, on the other hand, may want to retain a noncontrolling interest to participate in the future performance of the acquiree but have the right to sell its noncontrolling interest after a period of time. The seller could execute a put option over the noncontrolling interest with the acquirer.

We refer to these arrangements as equity contracts. Acquirers and sellers may enter into equity contracts for the following reasons:

- ▶ A seller may want to defer taxes on capital gains that would result from selling 100% of an entity. The seller may be willing to sell a controlling interest with a put option that gives it the right to sell the remaining interest or with a call option that gives the acquirer the right to acquire the remaining interest, or both.
- ▶ An acquirer may want flexibility in financing an acquisition.
- ▶ Put options and forward contracts give the seller an exit strategy for its retained interest.
- ▶ Call options, put options or forward contracts with a fair value exercise price create an incentive for the seller to remain involved with the acquiree and help make it successful.

Similar arrangements also may be entered into between a parent and the noncontrolling interest holders subsequent to an acquisition. Agreements between a parent and the noncontrolling interest holders may:

- ▶ Grant the noncontrolling interest holders an option to sell their remaining interests in the subsidiary to the parent (i.e., a written put option from the parent's perspective)
- ▶ Grant the parent an option to acquire the remaining interests held by the noncontrolling interest holders (i.e., a purchased call option from the parent's perspective)
- ▶ Obligate the parent to acquire and the noncontrolling interest holders to sell their remaining interests (i.e., a forward contract to purchase shares from the parent's perspective)
- ▶ Grant the parent a purchased call option and grant the noncontrolling interest holders a written put option (i.e., an arrangement similar to but not exactly the same as a forward contract)

Accounting for these types of arrangements can be difficult due to the complexity and volume of authoritative guidance that needs to be considered. The accounting often is affected by whether (1) the feature (e.g., call option, put option, forward contract) is considered embedded or freestanding and (2) the strike price is fixed, variable (according to a formula) or at fair value. A parent would need to carefully evaluate how these arrangements affect the classification and measurement of the noncontrolling interest, earnings per share, and the presentation of net income attributable to the parent, among other things.

See section 5.10 of our FRD, *Issuer's accounting for debt and equity financings*, for further interpretive guidance. Applying this guidance may result in presenting the equity as a redeemable noncontrolling interest. See section 23.3.2.1 for guidance on the presentation of redeemable noncontrolling interests in the reconciliation of changes in equity. See section 3.2.2 of our FRD, *Earnings per share*, for guidance on calculating earnings per share and the presentation of net income attributable to the parent.

16 Attribution of net income or loss and comprehensive income or loss

16.1 Attribution procedure

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

810-10-45-19

Revenues, expenses, gains, losses, net income or loss, and other comprehensive income shall be reported in the consolidated financial statements at the consolidated amounts, which include the amounts attributable to the owners of the parent and the noncontrolling interest.

810-10-45-20

Net income or loss and comprehensive income or loss, as described in Topic 220, shall be attributed to the parent and the noncontrolling interest.

Net income or loss and comprehensive income or loss should be attributed to the controlling and noncontrolling interests for all subsidiaries, regardless of whether the subsidiary is a voting interest entity or a VIE. While ASC 810 requires net income or loss and comprehensive income or loss to be attributed to the controlling and noncontrolling interests, it does not prescribe a method for making these attributions. We believe that net income or loss and comprehensive income or loss of a partially owned subsidiary should be attributed between controlling and noncontrolling interests based on the terms of a substantive profit-sharing agreement. If a substantive profit-sharing agreement does not exist, we generally believe the relative ownership interests in the subsidiary should be used. In the latter case, the attribution may be as simple as multiplying the net income or loss and comprehensive income or loss of the partially owned subsidiary by the relative ownership interests in the subsidiary.

We have observed that the SEC staff has asked public companies to enhance their disclosures by stating how such allocations among controlling and noncontrolling interests are made. Therefore, we believe it is appropriate to disclose the terms and effects of any material substantive profit-sharing arrangement.

Attributing comprehensive income or loss to the controlling and noncontrolling interest requires the allocation of other comprehensive income, including cumulative translation adjustments and reclassifications out of accumulated other comprehensive income (AOCI), to the noncontrolling interest. See section 4.4.4 of our FRD, *Foreign currency matters*, for guidance on attributing cumulative translation adjustments to noncontrolling interests and section C7.1.7.2, *Reporting reclassification adjustments out of AOCI – noncontrolling interests*, of our Accounting Manual for further guidance.

16.1.1 Substantive profit-sharing arrangements

We believe that a contractual arrangement that specifies how to attribute net income or loss and comprehensive income or loss among a subsidiary's owners should be used for financial reporting purposes if it is substantive. To be substantive, the terms of an arrangement should retain their economic outcome over time. Determining whether a profit-sharing arrangement is substantive is a matter of individual facts and circumstances requiring the use of professional judgment.

For example, care should be exercised when taxable earnings are allocated using a different formula than cash distributions and liquidating distributions. In these situations, the tax allocation should be carefully evaluated to ensure that the basis used for financial reporting purposes reflects the allocations of earnings

agreed to by the parties. ASC 970-323-35-16 and 35-17 provide guidance on this point. Additionally, if an arrangement used one allocation while it continued as a going concern, but used a different method for allocations upon liquidation, that may suggest that the prior allocations were not substantive.

Examples of profit-sharing arrangements could include:

- ▶ One investor is allocated all income generated from tax credits, while other investors receive all other operating income and losses.
- ▶ One investor receives a preferential return (e.g., the first \$X of income, or based on a specified internal rate of return).
- ▶ One investor is allocated all of the investee's interest expense; thereafter, distributions are allocated on a pro rata basis.

Excerpt from Accounting Standards Codification

Real Estate – General – Investments – Equity Method and Joint Ventures

Subsequent Measurement

970-323-35-16

Venture agreements may designate different allocations among the investors for any of the following:

- a. Profits and losses
- b. Specified costs and expenses
- c. Distributions of cash from operations
- d. Distributions of cash proceeds from liquidation.

970-323-35-17

Such agreements may also provide for changes in the allocations at specified times or on the occurrence of specified events. Accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph 970-323-35-10. To determine the investor's share of venture net income or loss, such agreements or arrangements shall be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with GAAP) will affect cash payments to the investor over the life of the venture and on its liquidation. Specified profit and loss allocation ratios shall not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis. For example, if a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them, there is no substance to the purported allocation of depreciation expense.

Paragraphs 970-323-35-16 and 35-17 apply to allocations among investments in real estate accounted for by the equity method. However, we believe the same concept of substance over form also applies to allocations of net income or loss and other comprehensive income or loss between controlling and noncontrolling interests. That is, a parent would need to analyze the agreements and arrangements to determine how a change in net assets of a less-than-wholly-owned subsidiary (determined in conformity with US GAAP) would affect cash payments to the parent over the life of the subsidiary and upon its liquidation. In some cases, an arrangement may attribute losses to the shareholders in a different manner than it attributes profits, and therefore, a parent should be careful to evaluate all elements of the arrangement when making attributions.

We believe a contractual term that requires one investor (e.g., the parent) to pay cash to another investor (e.g., a noncontrolling interest holder) should be considered carefully when evaluating the substance of a profit-sharing arrangement. Depending on the facts and circumstances, the cash payment may be part of a separate arrangement among the investors that is not directly related to the operations or earnings of the entity (e.g., a payment for services provided by one investor to another investor outside of the entity). When cash payments of this nature do not clearly and directly link to prior attributions of earnings or losses among the investors under the agreement, we believe they would not affect the attributions made for financial reporting purposes. Alternatively, in certain circumstances, payments from a separate arrangement may be clearly and directly linked to prior attributions and considered to be retroactively affecting or “unwinding” prior attribution. In these circumstances, the substance of that arrangement may represent a substantive profit-sharing arrangement and would need to be considered when determining attribution for financial reporting purposes.

Little implementation guidance exists on how to account for substantive profit-sharing arrangements. One approach applied in practice is the hypothetical-liquidation-at-book-value (HLBV) method. As described in more detail below, the use of such an approach is appropriate when the terms of the substantive profit-sharing arrangement are consistent with the calculation of HLBV. Under the HLBV approach, the parent’s share of the subsidiary’s earnings or loss is calculated by:

- ▶ The parent’s capital account at the end of the period assuming that the subsidiary was liquidated or sold at book value, plus
- ▶ Cash distributions received by the parent during the period, minus
- ▶ The parent’s new investments in the subsidiary during the period, minus
- ▶ The parent’s capital account at the beginning of the period assuming that the subsidiary was liquidated or sold at book value

The HLBV method would be applied using the subsidiary’s book values in accordance with US GAAP.

The HLBV method was discussed in detail in a proposed Statement of Position (SOP), *Accounting for Investors’ Interests in Unconsolidated Real Estate Investments*. However, the proposed SOP was never adopted. As a result, there is no authoritative guidance requiring the HLBV method. The HLBV method therefore should be considered only as an approach for how a parent might allocate net income or loss, including comprehensive income or loss, when a substantive profit-sharing arrangement exists and when the application of HLBV is consistent with such terms. Said differently, the parent should ensure that the application of the HLBV method is consistent with the economic substance of an arrangement and does not conflict with the attribution principle in ASC 810-10-45-20. Therefore, using the HLBV method (or any other methodology) to make such attributions is appropriate only if doing so reflects the terms of an existing substantive profit-sharing arrangement.

Determining whether the terms of an arrangement are substantive and whether the HLBV method (or any other allocation methodology) reflects that substance requires the use of professional judgment and a careful evaluation of the individual facts and circumstances. In evaluating the substance of the terms, the parent should consider whether the terms retain their economic outcome over time and whether subsequent events have the potential to retroactively affect or unwind prior allocations.

Illustration 16-1: Attribution based on a substantive profit-sharing arrangement

Investor A and Investor B are unrelated parties that form a partnership on 1 January 20X1. Investor A contributes \$200 in exchange for an 80% equity interest. Investor B contributes technology with a fair value of \$50 in exchange for the remaining 20% equity interest. Investor A controls and consolidates the partnership and records the 20% interest held by Investor B as noncontrolling interest.

There have not been any changes in ownership interests, and there were no additional contributions from or distributions to the investors from 1 January 20X1 through 31 December 20X3.

The Subsidiary does not distribute any dividends in any period. Intra-entity transactions and the effect of income taxes have been ignored to simplify this illustration.

The Subsidiary's book value of net assets and operating income (loss) are as follows:

	1 Jan X1	31 Dec X1	31 Dec X2	31 Dec X3
Net assets	\$ 200	\$ 150	\$ 320	\$ 560
Net income (losses)	-	\$ (50)	\$ 170	\$ 240

Under the terms of the substantive profit-sharing arrangement, Investor A would receive back its initial investment of \$200, plus an additional return of \$200. After Investor A has received these amounts, all remaining profits and losses are allocated pro rata between Investors A and B.

Analysis

Based on the terms of the substantive profit-sharing arrangement, the claim to net assets at book value would be as follows:

	1 Jan X1	31 Dec X1	31 Dec X2	31 Dec X3
Book value of net assets	\$ 200	\$ 150	\$ 320	\$ 560
Return of capital to Parent (up to original investment of \$200) [1]	(200)	(150)	(200)	(200)
Remaining profits to allocate	-	-	120	360
Return to Parent (up to a maximum of \$200) [2]	-	-	(120)	(200)
Remaining profits to allocate	-	-	-	160
80% pro rata to Parent [3]	-	-	-	(128)
20% pro rata to the noncontrolling interest [4]	-	-	-	(32)
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
HLBV capital of Parent [1+2+3]	\$ 200	\$ 150	\$ 320	\$ 528
HLBV capital of the noncontrolling interest	-	-	-	32

20X1:

If Subsidiary hypothetically liquidated its assets and liabilities at book value at 31 December 20X1, it would have \$150 available to distribute. Parent would receive \$150 as its return of capital according to the substantive profit-sharing arrangement. Therefore, during 20X1, Parent's claim on Subsidiary's book value decreased by \$50 (\$150 capital less initial capital of \$200), which Parent would recognize in 20X1 as its share of Subsidiary's losses. Since the entire loss under HLBV has been allocated to Parent, no income or losses would be attributed to the noncontrolling interest in the consolidated financial statements during 20X1, and 100% of the \$50 loss would be attributed to Parent.

20X2:

If Subsidiary hypothetically liquidated its assets and liabilities at book value at 31 December 20X2, it would have \$320 available to distribute. Parent would receive \$200 as its return of capital plus \$120 as part of its return, according to the substantive profit-sharing arrangement. Therefore, during 20X2, Parent's capital increased to \$320. Parent's share of Subsidiary's income for the year would be \$170 (\$320 in capital at 31 December 20X2 less \$150 in hypothetically liquidated capital at 31 December 20X1). Since all income under HLBV was allocated to Parent, no income or losses would be attributed to the noncontrolling interest in the consolidated financial statements during 20X2, and 100% of the \$170 income would be attributed to Parent.

20X3:

If Subsidiary hypothetically liquidated its assets and liabilities at book value at 31 December 20X3, it would have \$560 available to distribute. Parent would receive \$200 as its return of capital, \$200 as its return and 80% of the remaining net assets available for distribution ($\$160 \times 80\% = 128$), according to the substantive profit-sharing arrangement. Therefore, during 20X3, Parent's HLBV capital increased to \$528. Parent's share of Subsidiary's income for the year would be \$208 (\$528 in capital at 31 December 20X3 less \$320 in hypothetically liquidated capital at 31 December 20X3). Parent would record the following journal entry to attribute \$32 of Subsidiary's \$240 of income to the noncontrolling interest:

Net income attributable to the noncontrolling interest	\$ 32	
Noncontrolling interest		\$ 32

In summary, under HLBV, \$208 of Subsidiary's income was allocated to the Parent and \$32 was allocated to the noncontrolling interest in the consolidated financial statements during 20X3.

Illustration 16-2: Allocation of profits and losses

Entity A (Manager) forms a fund with an unrelated party, Entity B. Entity A receives a 2% management fee and a performance fee (carried interest) equivalent to 20% of profits. The 20% carried interest, which is legally an equity interest in the entity, is subject to a 10% cumulative hurdle that does not consider forecasting of profit or losses. The fund's net income and retained earnings are as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
Net income	\$ 15	\$ 30	\$ 25	\$ 30	\$ 0
Cumulative net income	\$ 15	\$ 45	\$ 70	\$100	\$100

Allocation of profit/losses to Manager and Entity B (amounts below do not reflect 2% management fee):

Total cumulative hurdle: \$50

	Year 1	Year 2	Year 3	Year 4	Year 5
Manager	\$ 0 ¹	\$ 0 ¹	\$ 4 ²	\$ 6 ³	\$ 0
Entity B (net income less amount allocated to Manager)	\$ 15	\$ 30	\$ 21	\$ 24	\$ 0

¹ No income is allocated to Manager since cumulative hurdle hasn't been met

² \$4 = (\$70 cumulative earnings – \$50 cumulative hurdle) x 20% carried interest

³ \$6 = (\$100 cumulative earnings – \$50 cumulative hurdle) x 20% carried interest – \$4 profit allocated in Year 3

16.1.2

Attribution of losses in excess of noncontrolling interest's carrying amount**Excerpt from Accounting Standards Codification****Consolidation – Overall*****Other Presentation Matters******810-10-45-21***

Losses attributable to the parent and the noncontrolling interest in a subsidiary may exceed their interests in the subsidiary's equity. The excess, and any further losses attributable to the parent and the noncontrolling interest, shall be attributed to those interests. That is, the noncontrolling interest shall continue to be attributed its share of losses even if that attribution results in a deficit noncontrolling interest balance.

ASC 810 requires losses to be attributed to the noncontrolling interest even when its basis in the subsidiary has been reduced to zero. As discussed in paragraphs B41 through B43 of the Background Information and Basis for Conclusions of FAS 160, under the economic entity concept, the noncontrolling interest, like the controlling interest, is considered equity of the consolidated group and participates in the risks and rewards of the subsidiary. All of the assets and liabilities and activities of the parent and subsidiaries are consolidated as if they were a single economic entity.

The FASB reasoned that it cannot be assumed that one party (i.e., the parent) would be more compelled to contribute capital to a subsidiary than another party (i.e., the noncontrolling interest holder) because any party that contributes capital would likely receive additional ownership interests or other consideration in return for its investment. As such, the noncontrolling interest holder's investment would not be protected or limited due to an assumption that the parent would provide additional capital to continue operations if needed. Therefore, the noncontrolling interest should be attributed its share of losses even if the noncontrolling interest balance becomes a deficit balance and is presented in noncontrolling interest in the equity section of the consolidated statement of financial position.

However, entities should carefully evaluate their facts and circumstances in determining the appropriate attribution of income and losses. For example, entities should carefully consider whether contractual arrangements may provide for disproportionate sharing of losses among the controlling and noncontrolling interests. See section 16.1.1 for additional considerations involving a substantive profit-sharing arrangement.

Question 16.1

When consolidating a VIE, if losses applicable to the noncontrolling interest exceed the noncontrolling interest holders' equity, should the excess losses applicable to the noncontrolling interest be charged to the primary beneficiary?

ASC 810-10's consolidation procedures are similar for VIEs and voting interest entities (i.e., as if the VIE has been consolidated based on voting interests). As such, when losses applicable to the noncontrolling interest exceed the noncontrolling interest holders' equity in a consolidated VIE, the excess and any further losses applicable to the noncontrolling interest should continue to be charged to the noncontrolling interest.

16.1.2.1

Distribution in excess of the noncontrolling interest's carrying amount

We generally believe that because the noncontrolling interest balance can be reduced below zero under ASC 810 (that is, the noncontrolling interest can have a debit balance), the controlling interest is not required to recognize a loss when distributions exceed the noncontrolling interest's carrying value. Instead, the noncontrolling interest balance is reduced below zero when the transaction is recorded. Illustration 16-3 demonstrates this concept using an example from the real estate industry where a deficit noncontrolling interest balance is more common.

Illustration 16-3: Distribution in excess of the noncontrolling interest's carrying amount

A real estate subsidiary has \$100 of equity. The controlling and noncontrolling shareholder own 80% and 20%, respectively, of the entity. As a result, the noncontrolling interest balance is \$20. The subsidiary's only asset is a building with a carrying amount of \$100 and a fair value of \$1,100.

Assume the subsidiary refinances the appreciated building by mortgaging the building for \$1,000 and distributes the proceeds to its owners in proportion to their ownership interests.

Analysis

The journal entries to record the proceeds from the refinancing and subsequent distribution of those proceeds in the consolidated financial statements are as follows:

Cash	\$ 1,000	
Mortgage liability		\$ 1,000
<i>To record the proceeds from the refinancing transaction</i>		
Noncontrolling interest	\$ 200	
Cash		\$ 200
<i>To record the distribution to the noncontrolling interest</i>		

As a result of these transactions, the noncontrolling interest has a debit balance of \$180.

16.1.3

Attribution to noncontrolling interests held by preferred shareholders**Excerpt from Accounting Standards Codification****Consolidation – Overall*****Derecognition*****810-10-40-2**

Section 480-10-25 does not require mandatorily redeemable preferred stock to be accounted for as a liability under certain conditions. If such conditions apply and the mandatorily redeemable preferred stock is not accounted for as a liability, then the entity's acquisition of a subsidiary's mandatorily redeemable preferred stock shall be accounted for as a capital stock transaction. Accordingly, the consolidated entity would not recognize in its income statement any gain or loss from the acquisition of the subsidiary's preferred stock. In the **consolidated financial statements**, the dividends on a subsidiary's preferred stock, whether mandatorily redeemable or not, would be included in noncontrolling interest as a charge against income.

When a subsidiary is funded with a combination of common and preferred shares, the parent should carefully consider how to attribute net income or loss and comprehensive income or loss between the controlling and noncontrolling interests.

The terms of preferred shares can vary significantly. Typically, preferred shareholders have priority over common shareholders to an entity's assets and earnings. Therefore, preferred stock, unlike common stock, generally does not represent a residual equity interest in an entity even though both represent, in legal form, an ownership interest in the entity.

Typically, preferred shareholders are entitled to a share of an entity's earnings up to a stated dividend. Often, preferred shareholders also are entitled to a liquidation preference that includes a par amount and cumulative unpaid dividends. Losses of the entity typically do not reduce the amount due to the preferred shareholders in liquidation (although economically a portion of those losses may be funded by the preferred stock).

We generally believe any net income and comprehensive income of a subsidiary should be allocated to the noncontrolling interest based on the preferred shares' stated dividend and liquidation rights, and any net losses and comprehensive losses of the subsidiary should not be allocated to the preferred shares. As a result, the balance of the preferred stock classified as a noncontrolling interest generally should be equal to its liquidation preference.

However, depending on the facts and circumstances, it may be appropriate to account for the preferred shares and related terms of the shareholders' agreement as a substantive profit-sharing arrangement. In this case, the attribution of net income or loss and comprehensive income or loss between the controlling and noncontrolling interests should follow the substantive terms of the arrangement. As a result, there may be circumstances in which the carrying amount of the noncontrolling interest might be less than the liquidation preference of the preferred shares. For example, this would be the case if an entity uses HLBV to account for a substantive profit-sharing arrangement and the liquidation preference of the preferred shares exceeds the book value of the entity. See section 16.1.1 for additional considerations involving substantive profit-sharing arrangements.

In some cases, the preferred shares may be more akin to traditional common stock and represent a residual equity interest in the entity. That is, the preferred shares are perpetual in nature, have no stated dividend and are not entitled to a liquidation preference. However, the equity interest may be called preferred stock because it participates disproportionately in returns (even though it participates in losses in the same preference and proportion as common stock). In these cases, we believe it would be appropriate for the parent to attribute net losses and comprehensive losses to both preferred stock and common stock classified as noncontrolling interest. See sections 3.2 and 3.2.1 of our FRD, *Earnings per share*, for guidance on calculating earnings per share with respect to preferred shares and related dividends. See section 16.1.8 for additional guidance when the preferred noncontrolling interests are redeemable.

The guidance above relates only to equity-classified preferred stock and should not necessarily be analogized to residual equity interests that provide preferential returns, which are common in partnerships. However, we believe an analogy may be appropriate for a class of security issued by a subsidiary that has a preference in distribution or liquidation rights over all other classes of equity securities issued by the subsidiary.

Refer to section 18.5.2 for further discussion of the accounting for issuances and redemptions of preferred stock noncontrolling interests.

Illustration 16-4: Attribution to noncontrolling interests held by preferred shareholders

Companies A, B and C form Entity X, which is designed to buy and manage an apartment building. Companies A and B contribute \$240 million and \$560 million in exchange for 30% and 70% of the common shares of Entity X, respectively. Company A has a controlling financial interest and consolidates Entity X. Company C contributes \$400 million in exchange for preferred shares that receive a 5% cumulative stated dividend per year. The preferred stock also is entitled to a liquidation preference, which includes the par amount and any cumulative unpaid dividends.

Company A has no other activities besides its investment in Entity X. The results of operations for Entity X in Years 1 through 3 are as follows (in millions):

	Year 1	Year 2	Year 3
Net income (loss)	\$ 60	\$ (10)	\$ 30

Analysis

Because Company C, the preferred shareholder, is entitled to a 5% stated dividend per year on its \$400 million in preferred shares, Company A would attribute net income (loss) of Entity X to the controlling and noncontrolling interests holders as follows:

	Year 1	Year 2	Year 3
Net income (loss)	\$ 60	\$ (10)	\$ 30
Less: Net income attributable to the preferred noncontrolling interest – Company C	\$ 20	\$ 20	\$ 20
Net income (loss) attributable to the common shares	\$ 40	\$ (30)	\$ 10
Net income (loss) attributable to the common noncontrolling interest – Company B	\$ 28	\$ (21)	\$ 7
Net income (loss) attributable to the controlling interest – Company A	\$ 12	\$ (9)	\$ 3

Although Entity X incurred a net loss in Year 2, the preferred noncontrolling interest would be attributed income associated with its stated dividend for that year.

Net income (loss) attributed to noncontrolling interests (Company B and Company C) would be presented as a single line item in Company A's consolidated financial statements. See section 23.3.1 for guidance on the presentation of noncontrolling interests in the consolidated statements of net income and comprehensive income and Illustration 23-3 for an example.

16.1.4**Attribution of goodwill impairment****Excerpt from Accounting Standards Codification****Intangibles – Goodwill and Other – Goodwill****Subsequent Measurement****350-20-35-57A**

If a reporting unit is less than wholly owned, the fair value of the reporting unit and the implied fair value of goodwill shall be determined in the same manner as it would be determined in a business combination accounted for in accordance with Topic 805 or an acquisition accounted for in accordance with Subtopic 958-805. Any impairment loss measured in the second step of the goodwill impairment test shall be attributed to the parent and the **noncontrolling interest** on a rational basis. If the reporting unit includes only goodwill attributable to the parent, the goodwill impairment loss would be attributed entirely to the parent. However, if the reporting unit includes goodwill attributable to both the parent and the noncontrolling interest, the goodwill impairment loss shall be attributed to both the parent and the noncontrolling interest.

Pending Content:**Transition Date:** (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 350-20-65-3

If a reporting unit is less than wholly owned, the fair value of the reporting unit as a whole shall be determined in accordance with paragraphs 350-20-35-22 through 35-24, including any portion attributed to the noncontrolling interest. Any impairment loss measured in the goodwill impairment test shall be attributed to the parent and the **noncontrolling interest** on a rational basis. If the reporting unit includes only goodwill attributable to the parent, the goodwill impairment loss would be attributed entirely to the parent. However, if the reporting unit includes goodwill attributable to both the parent and the noncontrolling interest, the goodwill impairment loss shall be attributed to both the parent and the noncontrolling interest.

350-20-35-57B

If all or a portion of a less-than-wholly-owned reporting unit is disposed of, the gain or loss on disposal shall be attributed to the parent and the noncontrolling interest.

Any goodwill impairment should be attributed to the controlling and noncontrolling interests on a rational basis. As previously stated, when a substantive profit-sharing arrangement does not exist, attributing net income or loss and comprehensive income or loss to the controlling and noncontrolling interests may be as simple as multiplying earnings by the relative ownership percentages. However, that approach may not be appropriate for attributing a goodwill impairment if a parent paid a premium to obtain control of an entity and that premium was not allocated proportionately to the controlling and noncontrolling interest. In this case, the controlling and noncontrolling interests' bases in acquired goodwill may not be proportionate to their ownership interests.

See sections 3.15 and 3A.15 of our FRD, *Intangibles – goodwill and other*, for more guidance on goodwill impairment testing when a noncontrolling interest exists.

16.1.5 Attribution related to business combinations

A reporting entity that acquires a business or initially consolidates a VIE measures the assets and liabilities of the business or VIE at fair value in the consolidated financial statements. These amounts may differ from the amounts recorded in the standalone financial statements of the business or VIE. That is, the purchase price allocation adjustments may not be pushed down to the standalone financial statements. See Appendix B of our FRD, *Business combinations*, for more guidance on pushdown accounting.

If such an entity is not wholly owned, when the parent attributes profits and losses to the noncontrolling interest, the net income should be based on the parent's basis in the consolidated financial statements (e.g., the depreciation and amortization should reflect the purchase price allocation adjustments), regardless of whether pushdown accounting is applied. This is because consolidated financial statements present the consolidated results of the parent and its subsidiaries as a single economic entity, as discussed in section 16.1.

16.1.5.1 Attribution related to business combinations before the adoption of FAS 141(R)

FAS 141(R) was effective for the first annual reporting period beginning on or after 15 December 2008 (that is, 1 January 2009, for calendar year-end companies) and was required to be adopted concurrently with FAS 160. FAS 141(R) was required to be adopted prospectively.

Business combinations achieved in stages before the adoption of FAS 141(R) (e.g., business combinations accounted for under FAS 141) generally followed step-acquisition accounting. Under step-acquisition accounting, the noncontrolling interest was not initially measured at fair value. For this reason and because FAS 141(R) could not be applied retrospectively, it is inappropriate to use the noncontrolling interest's relative ownership interest in the subsidiary to attribute net income or loss and comprehensive

income or loss related to business combinations completed before the adoption of FAS 141(R). Instead, the controlling and noncontrolling interests' bases in assets and liabilities recognized before the adoption of FAS 141(R) should continue to be used.

Illustration 16-5: Attribution related to an acquisition before FAS 141(R)

On 1 January 2005, Acquirer acquired a 60% controlling interest in Target, which had a definite-lived intangible asset with a \$100 fair value, a zero book value and a 10-year remaining useful life. On the acquisition date, Acquirer accounted for the business combination under FAS 141 and measured the intangible asset in its financial statements at \$60 (60% acquired at fair value plus 40% acquired at book value). Subsequent to the acquisition date, Acquirer recognized annual amortization expense of \$6 in its consolidated financial statements.

Analysis

The Acquirer would attribute 100% of the amortization expense to the controlling interest because the noncontrolling interest has no basis in the intangible asset.

This concept also extends to attributing impairment charges to the controlling and noncontrolling interests. That is, if the intangible asset becomes impaired after the acquisition date, the entire impairment charge would be allocated to the controlling interest.

If a reporting unit includes goodwill that is attributable only to a parent's basis in a partially owned subsidiary for which acquisition accounting was completed according to FAS 141, any goodwill impairment charge would be attributed entirely to the parent. See section 3.15 of our FRD, *Intangibles – Goodwill and other*, for further guidance.

16.1.6

Effect of attribution on a parent's effective income tax rate

A parent's effective income tax rate may be affected by the attribution of net income and losses and comprehensive income and losses to noncontrolling interests. For example, this is common for reporting entities that consolidate entities that do not pay income tax but instead distribute any taxable income to their respective investors (e.g., limited liability companies, limited partnerships). When a parent's effective income tax rate is significantly affected by the attribution of net income and losses and comprehensive income and losses to noncontrolling interests, we believe additional disclosure in the notes to the financial statements is required.

Illustration 16-6: Effect of attribution on an entity's effective tax rate

Entity A (a corporation) owns 60% of LP (a limited partnership) and consolidates LP. Entity A's statutory income tax rate and standalone effective tax rate are both 21%. LP pays no income tax because it distributes its taxable earnings to its investors. Each entity has the following standalone financial information.

	Entity A	LP
Income before income taxes	\$ 1,000	\$ 900
Income taxes	<u>210</u>	<u>-</u>
Net income	<u>\$ 790</u>	<u>\$ 900</u>

Entity A is required to pay income taxes on its portion of LP's earnings. Therefore, the income tax expense related to LP in Entity A's consolidated financial statements would be \$113 (\$900 x 60% interest x 21% tax rate).

The consolidated financial information for Entity A would be presented as follows.

	<u>Entity A Consolidated</u>
Income before income taxes (\$1,000 + \$900)	\$ 1,900
Income taxes (\$210 + \$113)	<u>323</u>
Net income	1,577
Net income attributable to noncontrolling interest (\$900 x 40%)	<u>360</u>
Net income attributable to controlling interest	<u>\$ 1,217</u>

Analysis

Based on Entity A's consolidated financial information, its consolidated effective tax rate would be 17% ($\$323 / \$1,900$). This amount is less than the 21% statutory income tax rate because consolidated income before income taxes includes \$360 of earnings allocable to the noncontrolling interest for which there is no tax expense provided.

We believe that this is required to be explained in the effective income tax rate reconciliation disclosed in the footnotes to the consolidated financial statements under ASC 740. An effective income tax rate reconciliation for Entity A is as follows:

Effective income tax rate reconciliation	
Statutory income tax rate	21.0%
Book income of consolidated partnership attributable to noncontrolling interest	<u>(4.0)</u>
Effective tax rate for controlling interest	<u>17.0%</u>

See section 12 of our FRD, *Income taxes*, for a discussion of additional income tax considerations related to attributing consolidated income taxes between the controlling and noncontrolling interests.

16.1.7

Attribution of dividends payable in nonmonetary assets

In some circumstances, a subsidiary may issue dividends payable in nonmonetary assets (e.g., merchandise, real estate, investments in unrelated entities). Pursuant to ASC 845-10-30-1 through 3 and ASC 845-10-30-10, nonmonetary dividends payable to noncontrolling interest holders should generally be recorded at fair value of the nonmonetary assets to be distributed if fair value is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution. Otherwise, the dividends should be recorded at the carrying amount of the nonmonetary assets distributed. When recognized at fair value, differences between the fair value and carrying amount of the nonmonetary assets distributed should be recognized as a gain or loss only to the extent of dividends paid to the noncontrolling interests, if any, and any gain or loss recognized should be allocated entirely to the noncontrolling interests. Nonmonetary dividends received by a parent or other companies under common control should be recorded at the subsidiary's carrying amount pursuant to ASC 805-50. See section C.4 of our FRD, *Business combinations*.

Special guidance applies to the distribution of nonmonetary assets that constitute a business in transactions commonly referred to as spin-offs. See ASC 845-10-30-10 and ASC 505-60 for additional guidance.

16.1.8

Attribution to redeemable NCI

As discussed in section 15.2, a parent may consolidate a subsidiary that is not wholly owned, but the noncontrolling interest holder may have the right to redeem those interests at a later date. Accounting for these arrangements can be difficult due to the complexity of authoritative guidance that needs to be considered.

To account for redeemable noncontrolling interests, a parent that is an SEC registrant would:

- ▶ First, account for the noncontrolling interest (NCI) under ASC 810 (including allocation of earnings, adjustments for dividends, etc.) as discussed throughout section 16.1.
- ▶ Second, apply the SEC staff's guidance in ASC 480, which could affect the classification (presented in the mezzanine rather than in equity), and if so, may also adjust the measurement of any NCI and the related earnings per share calculations.⁸⁷

The measurement guidance in ASC 480 is not applied in lieu of the accounting for NCI under ASC 810. Rather, it is an incremental measurement that starts with the ASC 810 carrying amount and adjusts for any increase (but not decrease) to the carrying amount of temporary equity as determined under ASC 480. Adjustments to the carrying amount of redeemable NCI from the application of this guidance in ASC 480 are recognized in retained earnings (or in additional paid-in capital (APIC) if there are no retained earnings). Temporary equity should be the greater of the amount determined under ASC 810 or the amount determined under ASC 480.

When applying ASC 480 to redeemable common stock noncontrolling interests at other than fair value, some registrants adjust net income attributable to the parent (as reported on the face of the income statement) for changes in the carrying amount of the redeemable equity securities. However, other registrants do not adjust net income attributable to the parent and only consider the effect of the redemption feature in the calculation of income available to common stockholders of the parent (which may be disclosed on the face of the income statement under SEC guidance). These two alternatives affect presentation and disclosure only, but the choice does not affect the amount of reported earnings per share. An accounting policy election should be applied consistently.

See sections 5.10 and C.4.2 of our FRD, *Issuer's accounting for debt and equity financings*, for additional guidance and examples on the accounting for redeemable noncontrolling interests and section 3.2.2 of our FRD, *Earnings per share*, for additional guidance of the policy election with respect to presentation of the income statement. See section 23.3.2.1 in this FRD for guidance on the presentation of redeemable noncontrolling interests in the reconciliation of changes in equity.

16.1.8.1

Attribution of dividends of a consolidated trust issuing trust preferred securities

In the rare circumstance when a sponsor consolidates a trust that issued trust preferred securities classified as a redeemable noncontrolling interest in temporary equity, dividends are presented as an allocation of income to the noncontrolling interest holders in the income statement. See section 5.4.3 for guidance on evaluating trust preferred securities for consolidation. See section 5.6 of our FRD, *Issuer's accounting for debt and equity financings*, for more information on the accounting for the issuance of trust preferred securities by a consolidated trust.

⁸⁷ Such guidance is encouraged but not required for parents that are not SEC registrants.

17 Intercompany eliminations

17.1 Procedures for eliminating intercompany balances and transactions

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

Procedures

810-10-45-1

In the preparation of **consolidated financial statements**, intra-entity balances and transactions shall be eliminated. This includes intra-entity open account balances, security holdings, sales and purchases, interest, dividends, and so forth. As consolidated financial statements are based on the assumption that they represent the financial position and operating results of a single economic entity, such statements shall not include gain or loss on transactions among the entities in the **consolidated group**. Accordingly, any intra-entity profit or loss on assets remaining within the consolidated group shall be eliminated; the concept usually applied for this purpose is gross profit or loss (see also paragraph 810-10-45-8).

810-10-45-2

The retained earnings or deficit of a **subsidiary** at the date of acquisition by the **parent** shall not be included in consolidated retained earnings.

810-10-45-4

When a subsidiary is initially consolidated during the year, the consolidated financial statements shall include the subsidiary's revenues, expenses, gains, and losses only from the date the subsidiary is initially consolidated.

810-10-45-8

If income taxes have been paid on intra-entity profits on **inventory** remaining within the consolidated group, those taxes shall be deferred or the intra-entity profits to be eliminated in consolidation shall be appropriately reduced.

Relationships

Foreign Currency Matters

810-10-60-3

For the elimination of intra-entity profits with foreign entities, see paragraph 830-30-45-10.

Entities within a consolidated group generally record transactions with each other in a manner similar to transactions with third parties. For example, an entity that sells assets to another entity within the consolidated group may record sales, cost of goods sold and profit even though there has not been a transaction outside of the consolidated group. Because income cannot be recognized by the consolidated group until it has been realized in a transaction with a third party, there may be unrealized intercompany profit or loss requiring elimination.

An entity required to consolidate another entity must apply consolidation procedures to present the results of operations and financial position of the group (that is, the parent and the entities it is required to consolidate) as a single consolidated entity. Only transactions and ownership interests with parties outside the consolidated group are presented. Therefore, the separate financial statements of each entity are combined and adjusted to eliminate intercompany transactions and ownership interests. This is consistent with the single economic entity concept.

Consolidated financial statements should not include any intercompany receivables, payables, investments, capital, revenues, costs of sales or profits or losses between the entities within the consolidated group. Any intercompany profit or loss on assets or liabilities remaining within the consolidated entity should be eliminated, resulting in the carrying amount of the assets and liabilities being adjusted to the historical carrying amount that existed before the intercompany transaction. For example, if inventories or other assets of a consolidated group are transferred between members of the consolidated group, intercompany revenues, cost of sales and profit or loss recorded by the transferor should be eliminated in consolidation. This practice is continued until the income is realized through a sale to outside parties or, in the case of depreciable assets, the asset is depreciated over its estimated useful life.

The elimination of intercompany losses should be consistent with the elimination of intercompany profits. For example, if losses have been recognized on inventory acquired in an intercompany transaction, they must be eliminated to report the inventory in the consolidated statement of financial position at its cost to the consolidated entity. Careful consideration should be given to the lower-of-cost-or-market test of inventory for the entity purchasing the inventory. The market value of the inventory must not be less than the selling entity's cost. If the market value is less than cost, the loss that would have otherwise been eliminated in consolidation should be adjusted downward. That is, intercompany losses should not be eliminated if they represent a lower-of-cost-or-market adjustment. See section 17.1.6 for additional discussion in a LIFO liquidation.

Intercompany balances and transactions are eliminated regardless of whether the subsidiary is a voting interest entity or a VIE. However, additional considerations apply when the subsidiary is a VIE with a noncontrolling interest, as discussed in section 17.1.2.

US GAAP provides a limited exception to the general principles on intercompany eliminations. Under ASC 980-810-45-1 and -2, if an inventory sale is from a nonregulated subsidiary to a regulated subsidiary (as defined in ASC 980), profits on these sales should not be eliminated in consolidation, if certain conditions are met.

ASC 740 requires companies to recognize the income tax effects of intercompany transfers of assets other than inventory when the transfers occur. However, no tax effect is recognized upon a sale or transfer of inventory if the inventory remains within a consolidated group. Refer to section 3.2.2 of our FRD, *Income taxes*, for further guidance.

Refer to section 4.3 of our FRD, *Foreign currency matters*, for guidance on the elimination of intra-entity transactions with foreign entities.

17.1.1

Effect of NCI on intercompany eliminations – overview

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

Procedures

810-10-45-18

The amount of intra-entity income or loss to be eliminated in accordance with paragraph 810-10-45-1 is not affected by the existence of a noncontrolling interest. The complete elimination of the intra-entity income or loss is consistent with the underlying assumption that consolidated financial statements represent the financial position and operating results of a single economic entity. The elimination of the intra-entity income or loss may be allocated between the parent and noncontrolling interests.

There is no difference in the amount of intercompany profit or loss that is eliminated on transactions between a parent and a wholly owned subsidiary or between a parent and a partially owned subsidiary. In either case, all transactions among entities in the consolidated group are considered internal transactions that must be completely eliminated (i.e., 100% of the profit or loss). However, for partially owned subsidiaries, the parent allocates that elimination between the controlling interests and the noncontrolling interests. ASC 810 is not prescriptive on how to perform this allocation for voting interest entities.

When a sale is from a parent to a subsidiary (downstream transaction), profit or loss is recognized by the parent. We believe the full amount of the eliminated intercompany profit or loss should be attributed to the controlling interest (i.e., legal claim approach). Otherwise, the parent would continue to recognize a portion of the unrealized income or loss in net income attributable to the controlling interest even though ASC 810-10-45-1 requires intercompany transactions to be eliminated in their entirety. We refer to this as the “legal claim” approach because the net income attributable to the noncontrolling interest is based on the net income or loss recognized by the subsidiary as a separate legal entity. See Illustration 17-3 for the legal claim approach. The legal claim approach also is required to be applied when the subsidiary is a VIE, as discussed in section 17.1.2.

Since ASC 810 does not provide prescriptive guidance on how to perform this allocation for voting interest entities, we believe that an entity may select, as an accounting policy choice, either the legal claim approach or a “partial attribution” approach when a subsidiary sells to the parent (upstream transaction).

Under the partial attribution approach, the elimination of the profit or loss is attributed to the controlling and noncontrolling interest proportionately. The net income attributable to the noncontrolling interest may be calculated using the subsidiary’s net income, less any intra-entity profit recognized by the subsidiary. See Illustration 17-4 for an example of the partial attribution approach. The partial attribution approach is not permitted when the subsidiary is a VIE.

When making the above allocations, an entity should consider the terms of any substantive profit-sharing arrangements, as discussed in section 16.1.1.

The following table summarizes the approaches that we believe are acceptable for attributing the elimination of intercompany profit or loss, based on whether the transaction is downstream or upstream and on whether the subsidiary is a voting interest entity or a VIE:

	Downstream	Upstream
Voting interest entity	Legal claim approach (see Illustrations 17-3 and 17-5 through 17-7 in section 17.2)	Accounting policy choice: <ul style="list-style-type: none"> ▶ Legal claim approach (see Figures 17-3 and 17-4 in Illustration 17-4 in section 17.2); ▶ Partial attribution approach (see Figures 17-5 and 17-6 in Illustration 17-4 in section 17.2)
VIE	Legal claim approach (see Illustration 17-2 in section 17.1.2)	Legal claim approach (see section 17.1.2 and see Figures 17-3 and 17-4 in Illustration 17-4 in section 17.2)

17.1.2

Effect of NCI on intercompany eliminations for VIEs

Excerpt from Accounting Standards Codification

Consolidation – Overall

Subsequent Measurement – Variable Interest Entities

810-10-35-3

The principles of **consolidated financial statements** in this Topic apply to primary beneficiaries’ accounting for consolidated **variable interest entities** (VIEs). After the initial measurement, the assets, liabilities, and **noncontrolling interests** of a consolidated VIE shall be accounted for in consolidated financial statements

as if the VIE were consolidated based on voting interests. Any specialized accounting requirements applicable to the type of business in which the VIE operates shall be applied as they would be applied to a consolidated **subsidiary**. The consolidated entity shall follow the requirements for elimination of intra-entity balances and transactions and other matters described in Section 810-10-45 and paragraphs 810-10-50-1 through 50-1B and existing practices for consolidated subsidiaries. Fees or other sources of income or expense between a **primary beneficiary** and a consolidated VIE shall be eliminated against the related expense or income of the VIE. The resulting effect of that elimination on the net income or expense of the VIE shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.

After a primary beneficiary initially consolidates a VIE, the primary beneficiary generally follows the same consolidation principles as a parent that consolidates a majority-owned subsidiary based on voting interests. As discussed in section 17.1, this means that intercompany balances and transactions are eliminated in their entirety, regardless of whether a VIE is wholly or partially owned.

While the consolidation guidance does not prescribe a method for attributing these eliminations for voting interest entities, as discussed in section 17.1.1, ASC 810 provides specific guidance for this attribution for VIEs in ASC 810-10-35-3:

Fees or other sources of income or expense between a primary beneficiary and a consolidated VIE shall be eliminated against the related expense or income of the VIE. The resulting effect of that elimination on the net income or expense of the VIE shall be attributed to the primary beneficiary (and **not** to noncontrolling interests) in the consolidated financial statements [emphasis added].⁸⁸

Therefore, a VIE's net income or loss, including other comprehensive income or loss, should be attributed to the primary beneficiary and noncontrolling interests based on each party's legal claim to profits or losses (i.e., legal claim approach), regardless of whether the transaction is upstream or downstream. Consideration should be given to the terms of any substantive profit-sharing arrangements, as discussed in section 16.1.1.

Illustration 17-1: Primary beneficiary with no equity charges VIE a management fee (downstream transaction illustrating legal claim approach)

Assume the following:

- ▶ Company P is the primary beneficiary of Company S, a VIE, and it has a variable interest in Company S through a contractually negotiated management fee in an arrangement that exposes Company P to risk of loss (see section 5.4.13.3).
- ▶ Company P holds no equity in Company S. All of the equity interests are held by an unrelated third party. Therefore, in consolidation, Company P records the equity interests as noncontrolling interests.
- ▶ During the year, Company P charges Company S a management fee of \$1,500, which is the only transaction between Company P and Company S during 20X6.

⁸⁸ See paragraph D55 of FIN 46(R). The FASB included this provision to address issues that arose when a primary beneficiary applied the attribution guidance under ARB 51 to consolidated VIEs when the primary beneficiary did not have an equity interest in a VIE but received fees or had other sources of income from the consolidated VIE. The application of ARB 51 would have resulted in allocating the entire fee to noncontrolling interest. As a result, the primary beneficiary would reflect no benefit of its contractual arrangement with the VIE.

**Consolidating workpaper to arrive at consolidated income statement, for year ended 31 December 20X6
(all amounts are in dollars)**

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Revenues	500,000	270,000			770,000
Cost of revenues	200,000	100,000			300,000
Gross profit	300,000	170,000			470,000
Selling and administrative	100,000	20,000			120,000
Intercompany expense	–	1,500		(1) 1,500	–
Intercompany revenue	1,500	–	(1) 1,500		–
Net income	201,500	148,500			350,000
Net income attributable to noncontrolling interest	–	–	(2) 148,500		148,500
Net income attributable to controlling interest	201,500	148,500		(3)	201,500

The workpaper illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated income statement, as follows:

- (1) Intercompany revenue and expense resulting from the management fee of \$1,500 paid to Company P are eliminated.
- (2) Net income of Company S is attributed to the noncontrolling interest, based on its legal claim. Under ASC 810-10-35-3, the effect of eliminating the intercompany management fee is attributed to Company P, the primary beneficiary, rather than to the noncontrolling interest. Therefore, net income attributable to the noncontrolling interest holder includes the expense for the \$1,500 management fee.
- (3) The net income attributed to Company P, the primary beneficiary, is \$201,500. This amount represents the net income earned by Company P of \$200,000, plus the \$1,500 management fee, based on its legal claims.

See Illustration 17-7 for an example of how the management fee is allocated when the primary beneficiary also owns an equity interest in its subsidiary. While the example relates to a voting interest entity, the same concepts can be applied to a primary beneficiary that owns equity in a VIE.

See the legal claim approach in Illustration 17-4 for an example of an upstream transaction with a VIE. While the example relates to a voting interest entity, the legal approach also is applied to a primary beneficiary of a VIE.

17.1.2.1

Accounting for liabilities of a VIE after initial consolidation

Many VIEs issue limited recourse obligations that limit the cash flows that can be used to settle the obligations of the VIE to those generated by the VIE's assets (or other collateral pledged to the VIE). In this situation, if the VIE incurs losses that exceed the investments of the primary beneficiary and the noncontrolling interest holders, the losses will be borne by other variable interest holders in the VIE upon its liquidation or termination and not by the primary beneficiary's stockholders or owners.

Therefore, questions arise about whether the primary beneficiary should recognize those excess losses upon consolidation and thereafter, or whether it could reduce the liabilities in the consolidated VIE to reflect the portion of the losses that ultimately will be absorbed by other variable interest holders.

ASC 810-10-35-3 states that after the initial measurement, the assets, liabilities and noncontrolling interests of a consolidated VIE should be accounted for in consolidated financial statements as if the entity were consolidated based on voting interests. Therefore, we believe the liabilities of a consolidated

VIE cannot be reduced and presented at settlement value unless they have been extinguished pursuant to the requirements of the applicable GAAP. Accordingly, losses would continue to be recognized and allocated to the controlling and noncontrolling interests as discussed in section 16.1.2.

A reporting entity also should consider whether embedded derivatives exist in its arrangements with VIEs. See section 3 of our FRD, *Derivatives and hedging*, for guidance on embedded derivatives.

17.1.3

Shares of a parent held by its subsidiary (reciprocal interest)

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

Procedures

810-10-45-5

Shares of the parent held by a subsidiary shall not be treated as outstanding shares in the consolidated statement of financial position and, therefore, shall be eliminated in the consolidated financial statements and reflected as treasury shares.

Shares of a parent held by its subsidiary should not be reflected as outstanding shares in the consolidated financial statements. Instead, the shares should be reflected as treasury shares in the consolidated financial statements. When there are noncontrolling interests in the subsidiary, the noncontrolling interest holders have an interest in the earnings or losses of the parent by virtue of the shares of the parent that the subsidiary owns. In this case, the subsidiary's equity in the earnings or losses of the parent company should be included in determining the total income attributable to the noncontrolling interest in the subsidiary.

Illustration 17-2: Presentation of shares of a parent held by its subsidiary in consolidated financial statements

Assume that P owns 80% of S, and S owns 10% of P. Net income of P and S is \$200,000 and \$100,000, respectively. In the consolidated financial statements of P, income attributable to the noncontrolling interest would be calculated as follows:

Net income of P (1)	\$ 200,000	
S ownership percentage in P	<u>10%</u>	
S interest in net income of P	20,000	
Noncontrolling ownership percentage in S	<u>20%</u>	\$ 4,000
Net income of S (2)	100,000	
Noncontrolling ownership percentage in S	<u>20%</u>	<u>20,000</u>
Total income attributable to the noncontrolling interest		<u>\$ 24,000</u>

(1) Excluding the net income of S attributable to P

(2) Excluding the net income of P attributable to S related to its interest in P

17.1.3.1

Presentation in the subsidiary's separate financial statements

ASC 810-10 addresses the accounting for shares of a parent held by its subsidiary in the parent's consolidated financial statements but does not address the accounting in the subsidiary's separate financial statements. Although a consensus was not reached, EITF 98-2 stated that a subsidiary should disclose its policy with regard to the accounting for a subsidiary's investments in the shares of its parent. Generally, we believe a subsidiary's investment in the shares of its parent should be treated in a manner similar to treasury stock. That is, we believe the subsidiary should present the investment as a contra-equity account in its separate financial statements, which is consistent with the tentative conclusion reached in EITF 98-2.

17.1.4 Intercompany derivative transactions

ASC 815 allows intercompany transactions to be used in hedging relationships, if certain conditions are met. See section 7.8 of our FRD, *Derivatives and hedging*, for more information.

17.1.5 Deferred taxes on dividends of foreign operations

Excerpt from Accounting Standards Codification

Consolidation – Overall

Relationships

Income Taxes

810-10-60-2

For deferred taxes on dividends of foreign operations, see paragraphs 740-10-25-39 through 25-41.

See section 5.3.1.1 of our FRD, *Income taxes*, for more information on deferred taxes on dividends of foreign operations.

17.1.6 Effect of intercompany inventory transfers on LIFO liquidation

Excerpt from Accounting Standards Codification

Consolidation – Overall

Recognition

Profits Resulting from Intercompany Transfers of LIFO Inventories

810-10-25-16

See paragraphs 810-10-55-2 through 55-4 for guidance on accounting for profits resulting from intercompany transfers of last-in, first-out (LIFO) inventories.

Implementation Guidance and Illustrations

LIFO Liquidation

810-10-55-2

These paragraphs expand on the guidance in paragraph 810-10-25-16. A last-in, first-out (LIFO) liquidation (also called a decrement) occurs when the number of units (or total base year cost if dollar value LIFO is used) in a LIFO pool at year end is less than that at the beginning of the year, causing prior years' costs, rather than current year's costs, to be charged to current year's income. For example, in periods of rising prices, prior years' costs are less than current year's costs and, in such periods, charging prior years' costs to current year's income results in reporting current year's net income higher than it would be reported without a liquidation.

810-10-55-3

Accounting for a LIFO liquidation is more complex with intra-entity transfers of inventories. Paragraph 810-10-10-1 states that the purpose of **consolidated financial statements** is to present the results of operations and the financial position of the **parent** and its subsidiaries as if the **consolidated group** were a single economic entity. Under that guidance intra-entity profit on assets remaining within the group shall be eliminated. Results of operations and financial position, therefore, shall not be affected solely because of inventory transfers within a reporting entity. Inventory transferred between or from LIFO pools may cause LIFO inventory liquidations that could affect the amount of intra-entity profit to be eliminated.

810-10-55-4

Many different approaches are used by entities in eliminating such profit. Each reporting entity shall adopt an approach that, if consistently applied, defers reporting intra-entity profits from transfers within a reporting entity until such profits are realized by the reporting entity through dispositions outside the consolidated group. The approach shall be suited to the entity's individual circumstances.

17.2

Examples

The following examples illustrate certain procedures for eliminating intercompany balances and transactions. Workpaper adjusting entries are numbered sequentially.

Illustration 17-3: Parent sells to a subsidiary (downstream transaction to a voting interest entity)

When a parent sells inventory to a subsidiary, a voting interest entity, and some or all of the inventory remains on hand at a period-end (downstream transaction), profit or loss is recognized by the parent. We believe the full amount of the eliminated intercompany profit or loss should be attributed to the controlling interest (i.e., a legal claim approach). Otherwise, the parent would continue to recognize a portion of the unrealized income or loss in income even though ASC 810-10-45-1 requires intercompany transactions to be eliminated in their entirety.

Assume that Company P owns an 80% interest in Company S and that the noncontrolling interest upon initial recognition is \$100,000, which in this case also equals the noncontrolling interest's share of net assets (\$500,000 x 20%).

The 1 January 20X6, beginning-of-year balance sheets for Company P and Company S are as follows (all amounts in dollars):

	<u>Company P</u>	<u>Company S</u>
Cash	-	300,000
Inventory	200,000	50,000
Buildings and equipment, net	-	150,000
Investment in Company S	(1) 400,000	-
Total assets	<u>600,000</u>	<u>500,000</u>
Current liabilities	100,000	-
Common stock	200,000	500,000
Retained earnings	300,000	-
Noncontrolling interest	-	-
Total liabilities and equity	<u>600,000</u>	<u>500,000</u>

- (1) Before consolidation, Company P accounts for its investment in Company S by recognizing its proportionate share of the carrying amount of the net assets of Company S, including its proportionate share of comprehensive income and losses and dividends.

Also assume that during the year Company P sells inventory to Company S. A summary of the effect of the transaction on Company P's income statement is as follows:

Revenues	\$ 100,000
Cost of sales	<u>60,000</u>
Gross profit	<u>\$ 40,000</u>

Also, assume that the inventory sale is the only intercompany transaction between Company P and Company S during 20X6. Further, the inventory remains on hand at Company S at year-end.

Figure 17-1: Consolidating workpaper to arrive at consolidated income statement, for year ended 31 December 20X6 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Revenues	500,000	270,000	(2) 100,000		670,000
Cost of revenues	200,000	100,000		(2) 60,000	240,000
Gross profit	300,000	170,000			430,000
Selling and administrative	100,000	20,000			120,000
Income from investment in Company S	120,000	-	(3) 120,000		-
Net income	320,000	150,000			310,000
Net income attributable to noncontrolling interest	-	-	(4) 30,000		30,000
Net income attributable to controlling interest	320,000	150,000			280,000

Figure 17-1 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated income statement, as follows:

- (2) Intercompany revenue and intercompany cost of revenue from the downstream sale are eliminated against inventory.
- (3) Intercompany income from investment recognized by Company P ($\$150,000 \times 80\%$) is eliminated.
- (4) Net income of Company S is attributed to the noncontrolling interest ($\$150,000 \times 20\%$) based on its legal claim to the net income of Company S. The elimination of the intercompany transaction is attributed to the controlling interest.

Figure 17-2: Consolidating workpaper to arrive at consolidated balance sheet, 31 December 20X6 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Cash	(5) 200,000	(5) 450,000			650,000
Intercompany receivable	100,000	-	(7) 100,000		-
Inventory	(5) 200,000	150,000	(8) 40,000		310,000
Buildings and equipment, net	-	150,000			150,000
Investment in Company S	(13) 520,000	-	(9) 520,000		-
Total assets	1,020,000	750,000			1,110,000
Current liabilities	(5) 200,000	-			200,000
Intercompany payable	-	100,000	(7) 100,000		-
Total liabilities	200,000	100,000			200,000
Common stock	200,000	500,000	(10) 500,000		200,000
Retained earnings	(6) 620,000	150,000	(11) 190,000		580,000
Total parent shareholders' equity	820,000	650,000			780,000
Noncontrolling interest	-	-	(12) 130,000		130,000
Total equity	820,000	650,000			910,000
Total liabilities and equity	1,020,000	750,000			1,110,000

Figure 17-2 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated balance sheet, as follows:

- (5) Cash, inventory and current liabilities are assumed to change due to other activity with third parties during the year that is not shown.
- (6) A rollforward of retained earnings is as follows:
- | | |
|------------------------------------|-------------------|
| Beginning balance | \$ 300,000 |
| Current year earnings of Company P | <u>320,000</u> |
| Ending balance | <u>\$ 620,000</u> |
- (7) Intercompany receivable and payable from the downstream sale are eliminated.
- (8) Intercompany profit remaining in inventory at year-end from the downstream sale is eliminated.
- (9) Company P's investment in Company S is eliminated.
- (10) Company S's common stock is eliminated.
- (11) Company S's retained earnings balance is eliminated (\$150,000) and the intercompany profit on the downstream sale recognized by Company P is eliminated (\$40,000).
- (12) Noncontrolling interest is recognized at its initial balance of \$100,000 (\$500,000 x 20%) plus the net income attributable to noncontrolling interest from Company S (\$30,000).
- (13) Company P's investment in Company S increased from \$400,000 to \$520,000 by its share of Company S's net income of \$120,000 (\$150,000 x 80%).

Illustration 17-4: Subsidiary sells to parent (upstream transaction)

When a subsidiary that is a voting interest entity sells to the parent (upstream transaction) and an intercompany profit or loss arises, the elimination of the profit or loss may be attributed to the controlling interest (i.e., legal claim approach) or to the controlling and noncontrolling interest proportionately (i.e., partial attribution approach), as an accounting policy choice. This Illustration shows the legal claim approach in Figures 17-3 and 17-4 and the partial attribution approach in Figures 17-5 and 17-6.

Assume that Company P owns an 80% interest in Company S and that the noncontrolling interest upon initial recognition is \$100,000, which also equals the noncontrolling interest's share of net assets (\$500,000 x 20%). The 1 January 20X6, beginning-of-year balance sheets for Company P and Company S are as follows (all amounts in dollars):

	Company P	Company S
Cash	-	300,000
Inventory	200,000	50,000
Buildings and equipment, net	-	150,000
Investment in Company S	(1) <u>400,000</u>	<u>-</u>
Total assets	<u>600,000</u>	<u>500,000</u>
Current liabilities	100,000	-
Common stock	200,000	500,000
Retained earnings	300,000	-
Noncontrolling interest	<u>-</u>	<u>-</u>
Total liabilities and equity	<u>600,000</u>	<u>500,000</u>

- (1) Before consolidation, Company P accounts for its investment in Company S by recognizing its proportionate share of the carrying amount of the net assets of Company S, including its proportionate share of comprehensive income and losses and dividends.

Also assume that, during the year, Company S sells inventory to Company P. A summary of the effect of the transaction on Company S's income statement is as follows:

Revenues	\$ 100,000
Cost of sales	<u>60,000</u>
Gross profit	<u>\$ 40,000</u>

Also, assume that the inventory sale is the only intercompany transaction between Company P and Company S during 20X6. Further, the inventory remains on hand at Company P at year-end.

Legal claim approach⁸⁹:

Figure 17-3: Consolidating workpaper to arrive at consolidated income statement, for year ended 31 December 20X6 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Revenues	500,000	270,000	(2) 100,000		670,000
Cost of revenues	<u>200,000</u>	<u>100,000</u>		(2) 60,000	<u>240,000</u>
Gross profit	300,000	170,000			430,000
Selling and administrative	100,000	20,000			120,000
Income from investment in Company S	<u>120,000</u>		(3) 120,000		<u>-</u>
Net income	320,000	150,000			310,000
Net income attributable to noncontrolling interest	<u>-</u>	<u>-</u>	(4) 30,000		<u>30,000</u>
Net income attributable to controlling interest	<u>320,000</u>	<u>150,000</u>			<u>280,000</u>

Figure 17-3 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated income statement using the legal claim approach, as follows:

- (2) Intercompany revenue and intercompany cost of revenue from the upstream sale are eliminated against the inventory.
- (3) Intercompany income from investment recognized by Company P (\$150,000 x 80%) is eliminated.
- (4) Net income of Company S is attributed to the noncontrolling interest (\$150,000 x 20%) based on its legal claim to the net income of Company S. The elimination of the intercompany transaction is attributed to the controlling interest.

⁸⁹ Although the subsidiary is a voting interest entity in this illustration, the legal claim approach is required to be applied if the subsidiary were a VIE, as discussed in section 17.1.2.

**Figure 17-4: Consolidating workpaper to arrive at consolidated balance sheet, 31 December 20X6
(all amounts in dollars)**

				Adjustments		Consolidated	
				Debit	Credit		
Cash	(5)	300,000	(5)	350,000		650,000	
Intercompany receivable		-		100,000	(7)	100,000	-
Inventory	(5)	200,000	(5)	150,000	(8)	40,000	310,000
Building, net		-		150,000			150,000
Investment in Company S	(13)	520,000		-	(9)	520,000	-
Total assets		<u>1,020,000</u>		<u>750,000</u>			<u>1,110,000</u>
Current liabilities	(5)	100,000	(5)	100,000			200,000
Intercompany payable		100,000		-	(7)	100,000	-
Total liabilities		<u>200,000</u>		<u>100,000</u>			<u>200,000</u>
Common stock		200,000		500,000	(10)	500,000	200,000
Retained earnings	(6)	620,000		150,000	(11)	190,000	580,000
Total parent shareholders' equity		<u>820,000</u>		<u>650,000</u>			<u>780,000</u>
Noncontrolling interest		-		-	(12)	130,000	130,000
Total equity		<u>820,000</u>		<u>650,000</u>			<u>910,000</u>
Total liabilities and equity		<u>1,020,000</u>		<u>750,000</u>			<u>1,110,000</u>

Figure 17-4 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated balance sheet using the legal claim approach, as follows:

- (5) Cash, inventory and current liabilities are assumed to change due to other activity with third parties during the year that is not shown.
- (6) A rollforward of retained earnings is as follows:

Beginning balance	\$ 300,000
Current year earnings of Company P	<u>320,000</u>
Ending balance	<u>\$ 620,000</u>
- (7) Intercompany receivable and payable from the upstream sale are eliminated.
- (8) Intercompany profit remaining in inventory at year-end from the upstream sale is eliminated.
- (9) Company P's investment in Company S is eliminated.
- (10) Company S's common stock is eliminated.
- (11) Company S's retained earnings balance of \$150,000 is eliminated plus \$40,000 of Company P's intercompany profit from the upstream sale recognized by Company S.
- (12) Noncontrolling interest is recognized at its initial balance of \$100,000 ($\$500,000 \times 20\%$) plus the net income attributable to noncontrolling interest from Company S of 30,000 ($\$150,000$ income of Company S $\times 20\%$).
- (13) Company P's investment in Company S increased from \$400,000 to \$520,000 by its share of Company S's net income of \$120,000 ($\$150,000 \times 80\%$).

Partial attribution approach:**Figure 17-5: Consolidating workpaper to arrive at consolidated income statement, for year ended 31 December 20X6 (all amounts in dollars)**

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Revenues	500,000	270,000	(2) 100,000		670,000
Cost of revenues	200,000	100,000		(2) 60,000	240,000
Gross profit	300,000	170,000			430,000
Selling and administrative	100,000	20,000			120,000
Income from investment in Company S	120,000		(3) 120,000		-
Net income	320,000	150,000			310,000
Net income attributable to noncontrolling interest	-	-	(4) 22,000		22,000
Net income attributable to controlling interest	320,000	150,000			288,000

Figure 17-5 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated income statement using the partial attribution approach, as follows:

- (2) Intercompany revenue and intercompany cost of revenue from the upstream sale are eliminated against the inventory.
- (3) Intercompany income from investment recognized by Company P ($(\$150,000) \times 80\%$) is eliminated.
- (4) Net income of Company S is attributed to the noncontrolling interest, including its proportionate share of the elimination of the intercompany transaction ($(\$150,000 - \$40,000) \times 20\%$).

Figure 17-6: Consolidating workpaper to arrive at consolidated balance sheet, 31 December 20X6 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Cash	(5) 300,000	(5) 350,000			650,000
Intercompany receivable	-	100,000	(7) 100,000		-
Inventory	(5) 200,000	(5) 150,000	(8) 40,000		310,000
Building, net	-	150,000			150,000
Investment in Company S	(13) 520,000	-	(9) 520,000		-
Total assets	1,020,000	750,000			1,110,000
Current liabilities	(5) 100,000	(5) 100,000			200,000
Intercompany payable	100,000	-	(7) 100,000		-
Total liabilities	200,000	100,000			200,000
Common stock	200,000	500,000	(10) 500,000		200,000
Retained earnings	(6) 620,000	150,000	(11) 182,000		588,000
Total parent shareholders' equity	820,000	650,000			788,000
Noncontrolling interest	-	-	(12) 122,000		122,000
Total equity	820,000	650,000			910,000
Total liabilities and equity	1,020,000	750,000			1,110,000

Figure 17-6 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated balance sheet using the partial attribution approach, as follows:

- (5) Cash, inventory and current liabilities are assumed to change due to other activity with third parties during the year that is not shown.

(6) A rollforward of retained earnings is as follows:

Beginning balance	\$ 300,000
Current year earnings of Company P	<u>320,000</u>
Ending balance	<u>\$ 620,000</u>

- (7) Intercompany receivable and payable from the upstream sale are eliminated.
- (8) Intercompany profit remaining in inventory at year-end from the upstream sale is eliminated.
- (9) Company P's investment in Company S is eliminated.
- (10) Company S's common stock is eliminated.
- (11) Company S's retained earnings balance of \$150,000 is eliminated plus \$32,000 of Company P's intercompany profit from the upstream sale recognized by Company S ($\$32,000 = \$40,000 \times 80\%$).
- (12) Noncontrolling interest is recognized at its initial balance of \$100,000 ($\$500,000 \times 20\%$) plus the net income attributable to the noncontrolling interest from Company S of \$22,000 ($(\$150,000 \text{ income of Company S} - \$40,000 \text{ upstream profit}) \times 20\%$).
- (13) Company P's investment in Company S increased from \$400,000 to \$520,000 by its share of Company S's net income of \$120,000 ($\$150,000 \times 80\%$).

The net income attributable to the controlling interest in Figure 17-5 in Illustration 17-4, which uses the partial attribution approach, exceeds the net income attributable to the controlling interest in Figure 17-4 by \$8,000 (\$288,000 versus \$280,000) because a portion of the elimination of the unrealized income that was recognized by the subsidiary has been allocated to the noncontrolling interest ($\$40,000 \times 20\% = \$8,000$). Net income of the consolidated entity (\$310,000) is the same in both examples because of the requirement to fully eliminate the intercompany income or loss.

Illustration 17-5: Parent makes an intercompany loan to a subsidiary and the interest is expensed (downstream, voting interest entity)

Assume that Company P owns an 80% interest in Company S, a voting interest entity, and that the noncontrolling interest upon initial recognition is \$100,000, which also equals the noncontrolling interest's share of net assets ($\$500,000 \times 20\%$). We believe the full amount of the elimination of the intercompany profit or loss should be attributed to the controlling interest (i.e., a legal claim approach).

The 1 January 20X6, beginning-of-year balance sheets for Company P and Company S are as follows (all amounts in dollars):

	<u>Company P</u>	<u>Company S</u>
Cash	500,000	300,000
Inventory	200,000	50,000
Buildings and equipment, net	-	150,000
Investment in Company S	(1) <u>400,000</u>	-
Total assets	<u>1,100,000</u>	<u>500,000</u>
Current liabilities	600,000	-
Common stock	200,000	500,000
Retained earnings	300,000	-
Noncontrolling interest	<u>-</u>	<u>-</u>
Total liabilities and equity	<u>1,100,000</u>	<u>500,000</u>

- (1) Before consolidation, Company P accounts for its investment in Company S by recognizing its proportionate share of the carrying amount of the net assets of Company S, including its proportionate share of comprehensive income and losses and dividends.

Assume the following:

- ▶ On 1 January 2006, Company P makes an intercompany loan to Company S for \$100,000 with an annual interest rate of 10%.
- ▶ Company S expenses the current-year interest on the intercompany loan and remits cash to Company P for the annual interest incurred on the intercompany loan.
- ▶ The loan is the only transaction between Company P and Company S during 20X6.

Figure 17-7: Consolidating workpaper to arrive at consolidated income statement, for year ended 31 December 20X6 (all amounts in dollars)

	Company P	Company S	Adjustments			Consolidated
			Debit		Credit	
Revenues	500,000	270,000				770,000
Cost of revenues	200,000	100,000				300,000
Gross profit	300,000	170,000				470,000
Selling and administrative	100,000	20,000				120,000
Interest income	10,000	-	(2)	10,000		-
Interest expense	-	10,000			(2)	10,000
Income from investment in Company S	112,000	-	(3)	112,000		-
Net income	322,000	140,000				350,000
Net income attributable to noncontrolling interest	-	-	(4)	28,000		28,000
Net income attributable to controlling interest	322,000	140,000				322,000

Figure 17-7 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated income statement, as follows:

- (2) Intercompany interest income and intercompany interest expense are eliminated.
- (3) Intercompany income from investment recognized by Company P (\$140,000 x 80%) is eliminated.
- (4) Net income of Company S is attributed to the noncontrolling interest (\$140,000 x 20%) based on its legal claim to the net income of Company S. The elimination of the intercompany transaction is attributed to the controlling interest.

The elimination of the intercompany interest income and expense has no effect on the consolidated net income of Company P and Company S. However, because Company S recognized an expense of \$10,000, Company P receives the benefit of its interest income to the extent the expense is attributable to the noncontrolling interest for \$2,000 (\$10,000 x 20%). This benefit is realized immediately because Company S recorded the full amount of the interest as a current period expense.

Figure 17-8: Consolidating workpaper to arrive at consolidated balance sheet, 31 December 20X6 (all amounts in dollars)

			Adjustments		Consolidated
	Company P	Company S	Debit	Credit	
Cash	(5) 200,000	(5) 440,000			640,000
Inventory	200,000	(5) 150,000			350,000
Buildings and equipment, net	-	150,000			150,000
Intercompany loan	100,000	-		(7) 100,000	-
Investment in Company S	(12) 512,000	-		(8) 512,000	-
Total assets	1,012,000	740,000			1,140,000
Current liabilities	(5) 200,000	-			200,000
Intercompany loan	-	100,000	(7) 100,000		-
Total liabilities	200,000	100,000			200,000
Common stock	200,000	500,000	(9) 500,000		200,000
Retained earnings	(6) 622,000	140,000	(10) 140,000		622,000
Total parent shareholders' equity	822,000	640,000			822,000
Noncontrolling interest	-	-		(11) 128,000	128,000
Total equity	822,000	640,000			950,000
Total liabilities and equity	1,022,000	740,000			1,150,000

Figure 17-8 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated balance sheet, as follows:

- (5) Cash, inventory and current liabilities are assumed to change due to other activity with third parties during the year that is not shown.
- (6) A rollforward of Company P's retained earnings is as follows:

Beginning balance	\$ 300,000
Current year earnings of Company P	<u>322,000</u>
Ending balance	<u>\$ 622,000</u>
- (7) Intercompany loan is eliminated.
- (8) Company P's investment in Company S is eliminated.
- (9) Company S's common stock is eliminated.
- (10) The retained earnings of Company S are eliminated.
- (11) Noncontrolling interest is recognized at its initial balance of \$100,000 plus the net income attributable to the noncontrolling interest (\$28,000).
- (12) Company P's investment in Company S increased from \$400,000 to \$512,000 by its share of Company S's net income of \$112,000 (\$140,000 x 80%).

Illustration 17-6: Parent makes an intercompany loan to a subsidiary and the interest is capitalized (downstream transaction, to a voting interest entity)

Assume the same facts as in Illustration 17-5, except:

- ▶ During the year, Company P makes an intercompany loan to Company S, a voting interest entity, with a principal amount of \$100,000 and an annual interest rate of 10%. The proceeds of the loan are used to construct a building.
- ▶ Company S capitalizes the current-year interest on the intercompany loan as part of the cost of the building and remits cash to Company P for the annual interest incurred on the intercompany loan.
- ▶ The loan is the only transaction between Company P and Company S during 20X6.

Figure 17-9: Consolidating workpaper to arrive at consolidated income statement, for year ended 31 December 20X6 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Revenues	500,000	270,000			770,000
Cost of revenues	200,000	100,000			300,000
Gross profit	300,000	170,000			470,000
Selling and administrative	100,000	20,000			120,000
Interest income	10,000	-	(1)	10,000	-
Interest expense	-	-			-
Income from investment in Company S	120,000	-	(2)	120,000	-
Net income	330,000	150,000			350,000
Net income attributable to noncontrolling interest	-	-	(3)	30,000	30,000
Net income attributable to controlling interest	330,000	150,000			320,000

Figure 17-9 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated income statement, as follows:

- (1) Intercompany interest income is eliminated.
- (2) Intercompany income from investment recognized by Company P (\$150,000 x 80%) is eliminated.
- (3) Net income of Company S is attributed to the noncontrolling interest (\$150,000 x 20%) based on its legal claim to the net income of Company S. The elimination of the intercompany transaction is attributed to the controlling interest.

Figure 17-10: Consolidating workpaper to arrive at consolidated balance sheet, 31 December 20X6 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Cash	200,000	340,000			540,000
Inventory	200,000	150,000			350,000
Buildings and equipment, net	-	260,000	(5)	10,000	250,000
Intercompany loan	100,000	-	(6)	100,000	-
Investment in Company S	(11) 520,000	-	(7)	520,000	-
Total assets	<u>1,020,000</u>	<u>750,000</u>			<u>1,140,000</u>
Current liabilities	200,000	-			200,000
Intercompany loan	-	100,000	(6)	100,000	-
Total liabilities	<u>200,000</u>	<u>100,000</u>			<u>200,000</u>
Common stock	200,000	500,000	(8)	500,000	200,000
Retained earnings	(4) 630,000	150,000	(9)	160,000	620,000
Total parent shareholders' equity	830,000	650,000			820,000
Noncontrolling interest	-	-	(10)	130,000	130,000
Total equity	<u>830,000</u>	<u>650,000</u>			<u>950,000</u>
Total liabilities and equity	<u>1,030,000</u>	<u>750,000</u>			<u>1,150,000</u>

Figure 17-10 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated balance sheet, as follows:

- (4) A rollforward of Company P's retained earnings is as follows:

Beginning balance	\$ 300,000
Current year earnings of Company P	<u>330,000</u>
Ending balance	<u>\$ 630,000</u>

- (5) Capitalized interest from outstanding intercompany loan is eliminated.
- (6) The intercompany loan is eliminated.
- (7) Company P's investment in Company S is eliminated.
- (8) Company S's common stock is eliminated.
- (9) The retained earnings of Company S are eliminated (\$150,000), and the interest income recognized by Company P on the intercompany loan is eliminated (\$10,000).
- (10) Noncontrolling interest is recognized at its initial balance of \$100,000 plus the net income attributable to noncontrolling interest from Company S (\$30,000).
- (11) Company P's investment in Company S increased from \$400,000 to \$520,000 by its share of Company S's net income of \$120,000 (\$150,000 x 80%).

Because Company S has capitalized the intercompany interest expense it paid as part of the cost of the building, the interest has not been expensed in the income statement of Company S. Company P does not receive any benefit of the interest income until the expense is recognized, which will occur as the building is depreciated by Company S.

Year 2

In Year 2, assume Company S depreciates the newly constructed building over 10 years, which results in annual depreciation expense of \$26,000 ($\$260,000 / 10 \text{ years} = \$26,000$) that is included in Company S's cost of revenues. This amount includes \$1,000 of depreciation, resulting from the capitalization of intercompany interest in Year 1 ($\$10,000 / 10 \text{ years}$). Also, to simplify the example, assume that (1) Company P had no other transactions during Year 2 and (2) Company S does not incur any additional interest expense in Year 2.

Figure 17-11: Consolidating workpaper to arrive at consolidated income statement, for year ended 31 December 20X7 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Revenues	-	400,000			400,000
Cost of revenues	-	250,000	(12)	1,000	249,000
Gross profit	-	150,000			151,000
Income from investment in Company S	120,000	-	(13)	120,000	-
Net income	120,000	150,000			151,000
Net income attributable to noncontrolling interest	-	-	(14)	30,000	30,000
Net income attributable to controlling interest	120,000	150,000			121,000

Figure 17-11 illustrates the elimination of intercompany transactions between Company P and Company S for the Year 2 consolidated income statement, as follows:

- (12) The depreciation from the capitalized interest on the intercompany loan (\$1,000) is eliminated.
- (13) The income from investment in Company S (\$120,000) is eliminated.
- (14) Net income of Company S is attributed to the noncontrolling interest (\$150,000 x 20%) based on its legal claim to the net income of Company S. The elimination of the intercompany transaction is attributed to the controlling interest.

Figure 17-12: Consolidating workpaper to arrive at consolidated balance sheet, 31 December 20X7 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated	
			Debit	Credit		
Cash	200,000	516,000			716,000	
Inventory	200,000	150,000			350,000	
Buildings and equipment, net	-	234,000	(16)	9,000	225,000	
Intercompany loan	100,000	-	(17)	100,000	-	
Investment in Company S	(23) 640,000	-	(18)	640,000	-	
Total assets	1,140,000	900,000			1,291,000	
Current liabilities	200,000	-			200,000	
Intercompany loan	-	100,000	(17)	100,000	-	
Total liabilities	200,000	100,000			200,000	
Common stock	200,000	500,000	(19)	500,000	200,000	
Retained earnings	(15) 750,000	300,000	(20)	310,000	(21) 1,000	741,000
Total parent shareholders' equity	950,000	800,000			941,000	
Noncontrolling interest	-	-	(22)	160,000	160,000	
Total equity	950,000	800,000			1,101,000	
Total liabilities and equity	1,150,000	900,000			1,301,000	

Figure 17-12 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated balance sheet in Year 2, as follows:

- (15) Current-year attributable share of income from Company S (\$150,000 x 80%) is added to retained earnings. A rollforward of this account is as follows:

Beginning balance	\$ 630,000
Attributable share of Company S net income	<u>120,000</u>
Ending balance	<u>\$ 750,000</u>

- (16) Capitalized interest expense from the prior year (\$10,000) less current-year depreciation (\$1,000) is eliminated.
- (17) The intercompany loan is eliminated.
- (18) Company P's investment in Company S is eliminated.
- (19) Company S's common stock is eliminated.
- (20) The retained earnings of Company S are eliminated (\$300,000) and the interest income recognized by Company P on the intercompany loan is eliminated (\$10,000).
- (21) Depreciation of \$1,000 from the capitalized interest on the intercompany loan is eliminated.
- (22) Noncontrolling interest is recognized at its initial balance of \$100,000 plus the net income attributable to noncontrolling interest from Company S of \$30,000 for both Years 1 and 2.
- (23) Company P's investment in Company S increased from \$520,000 to \$640,000 by its share of Company S's net income \$120,000 (\$150,000 x 80%).

Illustration 17-7: Parent charges subsidiary a management fee (downstream, voting interest entity)

Assume that Company P owns an 80% interest in Company S, a voting interest entity. We believe the full amount of the elimination of the intercompany profit or loss should be attributed to the controlling interest (i.e., a legal claim approach).

The 1 January 20X6, beginning-of-year balance sheets for Company P and Company S are as follows (all amounts in dollars):

	<u>Company P</u>	<u>Company S</u>
Cash	-	300,000
Inventory	200,000	50,000
Buildings and equipment, net	-	150,000
Investment in Company S	(1) <u>400,000</u>	<u>-</u>
Total assets	<u>600,000</u>	<u>500,000</u>
Current liabilities	100,000	-
Common stock	200,000	500,000
Retained earnings	300,000	-
Noncontrolling interest	-	-
Total liabilities and equity	<u>600,000</u>	<u>500,000</u>

- (1) Before consolidation, Company P accounts for its investment in Company S by recognizing its share of the carrying amount of the net assets of Company S of \$400,000 (\$500,000 * 80%), including its share of comprehensive income and losses and dividends.

Assume the following:

- ▶ During the year, Company P charges Company S a management fee of \$1,500.
- ▶ The management fee is the result of a contractual arrangement negotiated between Company P and Company S.
- ▶ The management fee is the only transaction between Company P and Company S during 20X6.

Figure 17-13: Consolidating workpaper to arrive at consolidated income statement, for year ended 31 December 20X6 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Revenues	500,000	270,000			770,000
Cost of revenues	200,000	100,000			300,000
Gross profit	300,000	170,000			470,000
Selling and administrative	100,000	20,000			120,000
Intercompany expense	-	1,500		(2) 1,500	-
Intercompany revenue	1,500	-	(2) 1,500		-
Income from investment in Company S	118,800	-	(3) 118,800		-
Net income	320,300	148,500			350,000
Net income attributable to noncontrolling interest	-	-	(4) 29,700		29,700
Net income attributable to controlling interest	320,300	148,500			320,300

Figure 17-13 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated income statement, as follows:

- (2) Intercompany revenue and expense resulting from the management fee of \$1,500 paid to Company P are eliminated.
- (3) The income from investment in Company S is eliminated.
- (4) Net income (inclusive of the management fee expense) of Company S is attributed to the noncontrolling interest ($\$148,500 \times 20\%$) based on its legal claim to the net income of Company S. The elimination of the intercompany transaction is attributed to the controlling interest.

Figure 17-14: Consolidating workpaper to arrive at consolidated balance sheet, 31 December 20X6 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Cash	(5) 200,000	(5) 350,000			550,000
Intercompany receivable	1,500	-		(7) 1,500	-
Inventory	(5) 200,000	(5) 150,000			350,000
Buildings and equipment, net	-	150,000			150,000
Investment in Company S	(12) 518,800	-		(8) 518,800	-
Total assets	920,300	650,000			1,050,000
Current liabilities	100,000	-			100,000
Intercompany payable	-	1,500	(7) 1,500		-
Total liabilities	100,000	1,500			100,000
Common stock	200,000	500,000	(9) 500,000		200,000
Retained earnings	(6) 620,300	148,500	(10) 148,500		620,300
Total parent shareholders' equity	820,300	648,500			820,300
Noncontrolling interest	-	-		(11) 129,700	129,700
Total equity	820,300	648,500			950,000
Total liabilities and equity	920,300	650,000			1,050,000

Figure 17-14 illustrates the elimination of intercompany transactions between Company P and Company S for the consolidated balance sheet, as follows:

(5) Cash and inventory are assumed to change due to other activity with third parties during the year that is not shown.

(6) A rollforward of retained earnings is as follows:

Beginning balance	\$ 300,000
Current year earnings of Company P	<u>320,300</u>
Ending balance	<u>\$ 620,300</u>

(7) Intercompany receivable and payable are eliminated.

(8) Company P's investment in Company S is eliminated.

(9) Company S's common stock is eliminated.

(10) Company S's retained earnings balance is eliminated.

(11) Noncontrolling interest is recognized at its initial balance of \$100,000 plus the net income attributable to noncontrolling interest from Company S (\$29,700).

(12) Company P's investment in Company S increased from \$400,000 to \$518,800 by its share of Company S's net income of \$118,800 ($\$148,500 \times 80\%$).

18 Changes in a parent's ownership interest in a subsidiary while control is retained

18.1 Introduction (updated August 2022)

A parent accounts for transactions that increase ownership of a subsidiary as equity transactions. That is, the parent adjusts the carrying amount of the noncontrolling interest to reflect the change in its ownership interest in the subsidiary. Any difference between (1) the fair value of the consideration paid and (2) the adjustment to the noncontrolling interest is recognized in equity attributable to the parent. The carrying amounts of the subsidiary's assets (including goodwill) and liabilities are not changed, and no gain or loss is recognized.

Likewise, transactions within the scope of ASC 810 that result in a decrease in ownership of a subsidiary without a loss of control are also accounted for as equity transactions.

Accounting for a change in interest in a subsidiary involves four key steps:

- ▶ Determining whether the parent retains control of the subsidiary (see section 18.2)
- ▶ Determining whether the transaction is within the scope of ASC 810 (see section 18.3)
- ▶ Recognizing the fair value of the consideration paid or received (see section 18.4)
- ▶ Determining the adjustment to the noncontrolling interest (see section 18.4)

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

Changes in a Parent's Ownership Interest in a Subsidiary

810-10-45-22

A parent's ownership interest in a subsidiary might change while the parent retains its controlling financial interest in the subsidiary. For example, a parent's ownership interest in a subsidiary might change if any of the following occur:

- a. The parent purchases additional ownership interests in its subsidiary.
- b. The parent sells some of its ownership interests in its subsidiary.
- c. The subsidiary reacquires some of its ownership interests.
- d. The subsidiary issues additional ownership interests.

The following chart summarizes ASC 810's accounting in the consolidated financial statements for changes in a parent's ownership interest in a subsidiary (when the transaction is within the scope of ASC 810-10-45-21A) while maintaining a controlling financial interest:

Parent acquires additional ownership interest in subsidiary (decrease NCI)	Parent sells a portion of its ownership interest in subsidiary (increase NCI)
<ul style="list-style-type: none"> ▶ Reduce noncontrolling interest based on proportion acquired ▶ Adjust APIC for difference between the amount by which noncontrolling interest is reduced and the amount of consideration paid ▶ Adjust AOCI with corresponding adjustment to APIC, as appropriate ▶ See Illustration 18-15 	<ul style="list-style-type: none"> ▶ Increase noncontrolling interest for proportion of parent's ownership interest sold ▶ Adjust APIC for difference between the amount by which noncontrolling interest is increased and the amount of consideration received ▶ Adjust AOCI with corresponding adjustment to APIC, as appropriate ▶ See Illustration 18-16
Subsidiary acquires shares from noncontrolling interest holder (decrease NCI)	Subsidiary issues common shares to noncontrolling interest holder (increase NCI)
<ul style="list-style-type: none"> ▶ Calculate shares effectively acquired by parent and decrease noncontrolling interest for proportion of parent's ownership interest acquired ▶ Adjust APIC for difference between the amount by which noncontrolling interest is reduced and the amount of consideration paid ▶ Adjust AOCI with corresponding adjustment to APIC, as appropriate ▶ See Illustration 18-18 	<p><i>The following applies when common stock is issued; see sections 18.5.2 and 18.5.3 for guidance on the issuance of preferred stock or partnership units.</i></p> <ul style="list-style-type: none"> ▶ Calculate shares effectively sold by parent and increase noncontrolling interest for proportion of parent's ownership interest sold ▶ Adjust APIC for difference between the amount by which noncontrolling interest is increased and the amount of consideration received ▶ Adjust AOCI with corresponding adjustment to APIC, as appropriate ▶ See Illustration 18-17

18.2

Retaining a controlling financial interest (updated August 2022)

A parent first evaluates whether a transaction causes it to lose control of the subsidiary, or whether it retains control of the subsidiary but its economic interest in that subsidiary has changed.

A primary beneficiary may acquire or dispose of a noncontrolling interest in a consolidated VIE. A primary beneficiary's acquisition or disposal of ownership interests may be a reconsideration event that requires reassessment of whether the legal entity is a VIE and whether the party designated as the primary beneficiary has changed. See section 12 for further guidance.

If, after making these reassessments, the primary beneficiary remains the same (i.e., a controlling financial interest is maintained), and the transaction is in the scope of ASC 810, the acquisition or disposal of a noncontrolling interest should be treated as an equity transaction, consistent with ASC 810-10-45-23.

If the subsidiary is a voting interest entity, the parent evaluates whether the subsidiary is still a voting interest entity (see section 12 for guidance on reconsideration events) after the transaction, and if so, whether it still has a controlling financial interest under the voting model. If it does, and the transaction is in the scope of ASC 810, the acquisition or disposal of a noncontrolling interest is accounted for as an equity transaction.

18.3 Scope of guidance in ASC 810 on a change in interest (without loss of control) (updated August 2022)

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

Changes in a Parent's Ownership Interest in a Subsidiary

810-10-45-21A

The guidance in paragraphs 810-10-45-22 through 45-24 applies to the following:

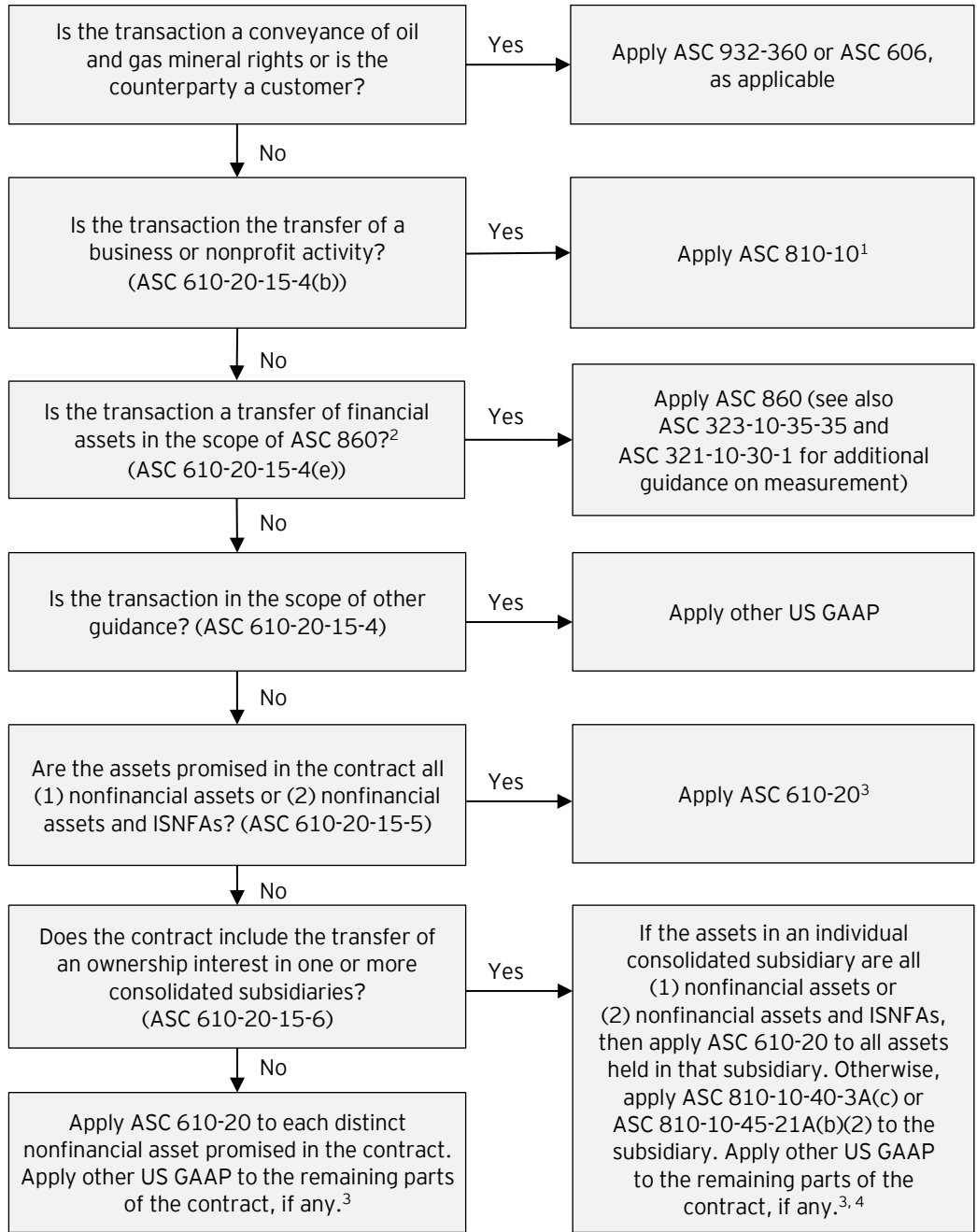
- a. Transactions that result in an increase in ownership of a subsidiary
- b. Transactions that result in a decrease in ownership of either of the following while the parent retains a controlling financial interest in the subsidiary:
 1. A subsidiary that is a business or a **nonprofit activity**, except for either of the following:
 - i. Subparagraph superseded by Accounting Standards Update No. 2017-05.
 - ii. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360).
 - iii. A transfer of a good or service in a contract with a customer within the scope of Topic 606.
 2. A subsidiary that is not a business or a nonprofit activity if the substance of the transaction is not addressed directly by guidance in other Topics that include, but are not limited to, all of the following:
 - i. Topic 606 on revenue from contracts with customers
 - ii. Topic 845 on exchanges of nonmonetary assets
 - iii. Topic 860 on transferring and servicing financial assets
 - iv. Topic 932 on conveyances of mineral rights and related transactions
 - v. Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

The change in interest accounting in ASC 810 applies to all transactions that result in an increase in ownership of a subsidiary. See section 18.3.1 for guidance.

The scope of ASC 810-45-22 through 24 only applies to a decrease in interest when a controlling financial interest is retained for:

- ▶ A subsidiary that is a business or a nonprofit activity, except for a conveyance of oil and gas mineral rights and revenue transactions from contracts with customers in the scope of ASC 606 (see section 18.3.2.1)
- ▶ A subsidiary that is not a business or a nonprofit activity, but the substance of the transaction is not addressed directly by guidance in other ASC Topics (see section 18.3.2.2)

ASC 810 lists ASC Topics to consider when a parent determines whether the substance of the transaction is addressed by other US GAAP. However, that list is not exhaustive. Below is a flowchart to help a reporting entity determine when to apply ASC 810 or other guidance, which is adapted from a decision tree in ASC 610-20-15-10:



¹ Any conveyance of an oil and gas mineral right that is accounted for under ASC 932-360-40 is outside the scope of ASC 810's derecognition provisions. Spin-offs and split-offs of businesses are addressed by ASC 505-60.

² Sales of equity method investments, even if those investees only hold nonfinancial assets, such as real estate, are accounted for under ASC 860, unless a scope exception applies.

³ For transactions within the scope of ASC 610-20, see our FRD, *Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)*, for further guidance. ASC 610-20 is applied to each distinct asset promised in the contract. If the contract includes terms or other contractual obligations that are not assets of the seller (e.g., guarantees), these aspects of the contract are separated and accounted for under other US GAAP.

⁴ An entity evaluates all of the assets transferred, collectively, in the contract. If substantially all of the fair value of all of the assets is not concentrated in nonfinancial assets, the entity evaluates each individual consolidated subsidiary (i.e., the entity determines whether substantially all of the fair value of the assets in each subsidiary is concentrated in nonfinancial assets).

18.3.1 **Increases in a parent's ownership interest in a subsidiary (updated August 2022)**

A parent may increase its ownership interest in a subsidiary by (1) purchasing additional outstanding shares of the subsidiary, (2) causing the subsidiary to reacquire a portion of outstanding shares (a treasury stock buyback) or (3) causing the subsidiary to issue additional shares to the parent. These transactions are all within the scope of ASC 810 and accounted for as equity transactions, as described in section 18.4.

18.3.2 **Scope of ASC 810 for decreases in a parent's ownership interest in a subsidiary without loss of control (updated August 2022)**

A parent may decrease its ownership interest in a subsidiary by (1) selling a portion of the subsidiary's shares it holds or (2) causing the subsidiary to issue additional shares. These transactions are accounted for as equity transactions when the transaction is within the scope of ASC 810.

However, the guidance in ASC 810 for the accounting for decreases in a parent's interest in a subsidiary when the parent retains control includes scope exceptions, which are discussed in the following sections.

18.3.2.1 **Decrease in interest in a subsidiary that is a business (updated August 2022)**

A decrease in interest in a subsidiary that is a business or nonprofit activity while control is retained generally is accounted for under ASC 810. However, this guidance does not apply to oil and gas conveyances and revenue transactions with customers (discussed below in sections 18.3.2.1.1 and 18.3.2.1.2, respectively).

The definition of a business in ASC 805 requires a reporting entity to first evaluate whether 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. Quantitatively evaluating whether the substantially all threshold is met may be challenging because a reporting entity wouldn't otherwise be required to determine the fair value of all of the assets in a decrease in interest transaction. However, in many transactions, the transferred set of assets will clearly be a business, and the transaction will be in the scope of ASC 810. In other transactions, a reporting entity may need to apply judgment. See section 2.1.3 of our FRD, ***Business combinations***, for further discussion of the definition of a business.

18.3.2.1.1 **Scope exception for oil and gas conveyances**

Any conveyance of an oil and gas mineral right that is accounted for under ASC 932-360-40 is outside the scope of ASC 810's derecognition provisions and ASC 810's provisions regarding the decrease in ownership of a subsidiary while the parent retains a controlling financial interest. A reporting entity also should consider the intra-entity elimination guidance in section 6.2.1 of our FRD, ***Equity method investments and joint ventures***, when the recipient is an equity method investee and the transaction is in the scope of ASC 932.

However, if a reporting entity sells a portion of a subsidiary or a group of assets that include oil and gas mineral rights (or contributes it to another entity), the transaction may be more appropriately accounted for under ASC 810 instead of ASC 932. A reporting entity should consider the guidance and illustrations in ASC 932 to determine whether a transaction represents a conveyance of a mineral property. If a transaction is not addressed directly by the guidance in ASC 932, it should be accounted for under ASC 810 unless other US GAAP applies.

Illustration 18-1: Oil and gas transaction not in the scope of ASC 810

O&G Co. owns a 100% gas mineral interest in a property in Colorado. O&G Co. assigns an operating interest to an unrelated third party, Drilling Co., and retains a non-operating interest in the property. The transaction requires Drilling Co. to drill, develop and operate the property. O&G Co. will participate in the production profits after Drilling Co. recoups its costs.

Analysis

The accounting for this transaction (a pooling of assets in a joint undertaking) is addressed in ASC 932-360-55-3. Therefore, the transaction should be accounted for in accordance with ASC 932 and not ASC 810.

Illustration 18-2: Oil and gas transaction in the scope of ASC 810

O&G Co. owns 100% of an operating subsidiary, Foreign Sub. Foreign Sub has oil and gas mineral properties and other energy-related operations. O&G Co. sells a 20% interest in those operations to Purchase Co. without a loss of control.

Analysis

This type of transaction is not addressed directly in the mineral property conveyance guidance in ASC 932 and, therefore, should be accounted for under the derecognition guidance in ASC 810. We believe ASC 810 is the most appropriate guidance because this transaction represents the decrease in ownership of a business that happens to include oil and gas mineral properties.

18.3.2.1.2**Scope exception for revenue contracts with customers**

Regardless of whether the transferred assets meet the definition of a business, transactions with customers (i.e., the sale of goods or services that are an output of the entity's ordinary activities) are within the scope of ASC 606.⁹⁰ For the definition of a customer and accounting for transactions within the scope of ASC 606, see our FRD, *Revenue from contracts with customers (ASC 606)*, for further guidance.

18.3.2.2**Decreases in ownership interest of a subsidiary that is not a business or a nonprofit activity**

If a decrease in ownership occurs in a subsidiary that is not a business or nonprofit activity, a reporting entity first needs to evaluate the substance of the transaction and identify whether other literature (e.g., transfers of financial assets as discussed in ASC 860, revenue recognition as discussed in ASC 606, sale of nonfinancial assets as discussed in ASC 610-20) provides relevant guidance. If other guidance does not apply, a reporting entity should apply ASC 810. This process is illustrated in the flowchart in section 18.3.

ASC 810 lists ASC Topics to consider when the parent determines whether the substance of the transaction is addressed by other US GAAP, as discussed in the following sections. However, this list is not exhaustive.

⁹⁰ If an entity sells a nonfinancial asset to a counterparty that is not an output of its ordinary activities and also sells goods or services to the counterparty that are the output of its ordinary activities, we believe the counterparty is considered a customer for the goods or services but not for the sale of the nonfinancial asset. See section 2.2 of our FRD, *Revenue from contracts with customers (ASC 606)*, for further details.

18.3.2.2.1 **Decrease in interest – substance addressed by ASC 606 (added August 2022)**

Transactions with customers (i.e., the sale of goods or services that are an output of the entity's ordinary activities) are within the scope of ASC 606. Therefore, if an entity's ordinary activity is to sell real estate, the entity will account for a decrease in interest in a subsidiary that holds real estate as a result of a transaction with a customer in accordance with ASC 606. For the definition of a customer and accounting for transactions within the scope of ASC 606, see our FRD, [Revenue from contracts with customers \(ASC 606\)](#), for further guidance.

18.3.2.2.2 **Decrease in interest – substance addressed by ASC 845**

Some exchanges of products held for sale in the ordinary course of business (inventory) are within the scope of ASC 845. Nonreciprocal transactions generally also are in the scope of ASC 845. See section N1.2, [Nonmonetary transactions](#), of our Accounting Manual for guidance.

A decrease in interest in a subsidiary that is not a business without a loss of control that is in substance a nonmonetary exchange would be accounted for under ASC 845, not ASC 810.

18.3.2.2.3 **Decrease in interest – substance addressed by ASC 860**

A decrease in interest in a subsidiary that holds only financial assets without a loss of control of the subsidiary, may be a transaction that is in substance within the scope of ASC 860, not within ASC 810. However, a parent should carefully consider the scope of ASC 860 before applying that guidance.⁹¹

A sale of a financial asset (e.g., an equity method investment) is generally in the scope of ASC 860,⁹² unless the financial asset is determined to be an in substance nonfinancial asset (ISNFA) as discussed in section 2.4.1 of the FRD, [Gains and losses from the derecognition of nonfinancial assets \(ASC 610-20\)](#). That is, a financial asset, including an equity method investment, is in the scope of ASC 610-20 if it is transferred in a contract as part of a group of assets and substantially all of the fair value of the group of assets is concentrated in nonfinancial assets (and no other scope exceptions from ASC 610-20 apply).⁹³

Reporting entities do not look through to the underlying assets and liabilities in an unconsolidated entity in which they hold an equity investment to determine which derecognition guidance to apply. Instead, reporting entities evaluate the form of the asset (e.g., an equity method investment) held by the subsidiary in which there is a decrease in interest to determine the appropriate derecognition guidance. Therefore, a reporting entity accounts for a decrease in interest in a subsidiary that holds an investment in an unconsolidated entity that is not an ISNFA as a transfer of the investment (a financial asset), not a transfer of the underlying assets and liabilities held by the unconsolidated investee (which might include nonfinancial assets).⁹⁴

However, one of the first considerations for a transfer of financial assets to be accounted for as a sale under ASC 860 in the consolidated financial statements of the transferor is whether the transferee would be consolidated by the transferor. That is because a sale to a consolidated affiliate would not result in a transfer of the risks and rewards of ownership to new owners. Therefore, even if the transaction is within the scope of ASC 860, if the parent retains control of the subsidiary that holds financial assets, there may be no gain or loss on the transaction, and it likely will be accounted for as a failed sale. See sections 1.4 and section 8 of our FRD, [Transfers and servicing of financial assets](#), for more guidance.

⁹¹ In determining whether the exchange is accounted for under ASC 860, entities should consider whether the exchange meets the definition of a "transfer" or is specifically exempted from its scope (e.g., the exchange involves investments by owners or distributions to owners of a business entity (ASC 860-10-15-4(f))).

⁹² Examples of other transactions that may be in the scope of ASC 860 include transfers of investments accounted for under ASC 320, ASC 321, ASC 325, ASC 815 or ASC 825 that are not ISNFAs.

⁹³ ASC 610-20 provides guidance on how entities evaluate whether the sale or transfer of an ownership interest in one or more consolidated subsidiaries is in its scope or in the scope of other US GAAP. See sections 2.1 and 2.6 of our FRD, [Gains and losses from the derecognition of nonfinancial assets \(ASC 610-20\)](#).

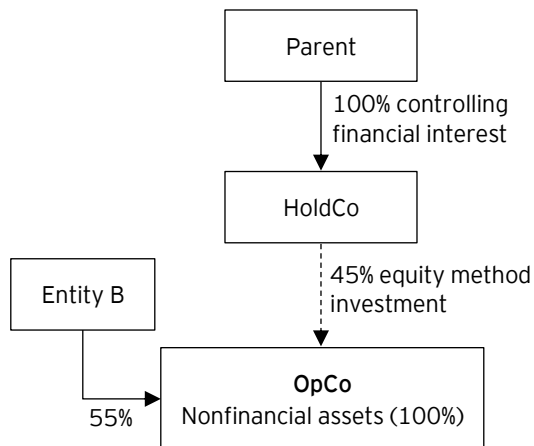
⁹⁴ See ASC 860-10-55-14.

The following example illustrates how to apply the scoping guidance and the flowchart in section 18.3 to a transaction in which a parent sells a noncontrolling interest in a subsidiary that holds an equity method investment.

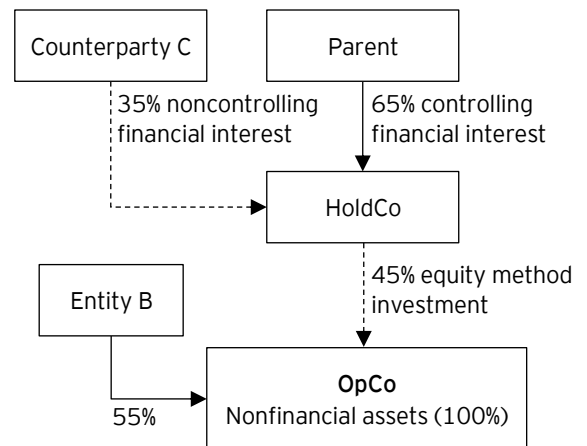
Illustration 18-3: Partial sale of a consolidated entity that holds an equity method investment

Parent owns a 100% controlling interest in HoldCo. HoldCo's only asset is a 45% equity method investment in OpCo. OpCo holds only nonfinancial assets. Parent sells a 35% noncontrolling interest in HoldCo to Counterparty C. The transaction is not with a customer, so it is not in the scope of ASC 606. In addition, HoldCo does not meet the definition of a business.

Before:



After:



Analysis

Since HoldCo's sole asset is a single equity method investment (i.e., a single financial asset), Parent evaluates the transfer and concludes that, in substance, it is transferring a financial asset in the scope of ASC 860. The transaction is not in the scope of ASC 610-20, even though all of the fair value of OpCo's assets is concentrated in nonfinancial assets. This is because Parent does not "look through" to evaluate the underlying assets of OpCo since it only has a noncontrolling interest (equity method investment) in OpCo. Instead, Parent evaluates the form of the asset that is transferred (e.g., a noncontrolling interest in HoldCo, which only holds an equity method investment in OpCo) to determine the appropriate derecognition guidance. This conclusion would not change even if the assets held by OpCo met the definition of a business.

The transaction is not in the scope of ASC 810 because Parent is not transferring control of a business, and the substance of the transaction is addressed by other guidance (in this case, ASC 860). However, because the Parent continues to consolidate HoldCo, it would fail sale accounting under ASC 860. Refer to section 1.4 and section 8 of our FRD, *Transfers and servicing of financial assets*, for guidance.

Note: If HoldCo controlled OpCo, Parent would look through HoldCo and consider the nature of the assets held by OpCo to determine which guidance applies to the transaction (e.g., ASC 606, ASC 810, ASC 610-20).

18.3.2.2.4 ***Decrease in interest – substance addressed by ASC 932 (added August 2022)***

Any conveyance of an oil and gas mineral right that is accounted for under ASC 932-360-40 is outside the scope of ASC 810's provisions regarding the decrease in ownership of a subsidiary while the parent retains a controlling financial interest. Refer to section 18.3.2.1.1 for guidance.

An entity also should consider the intra-entity elimination guidance in section 6.2.1 of our FRD, ***Equity method investments and joint ventures***, when the recipient is an equity method investee and the transaction is in the scope of ASC 932.

18.3.2.2.5 ***Decrease in interest – substance addressed by ASC 610-20 (updated August 2022)***

ASC 610-20 applies to transfers of nonfinancial assets, including ISNFAs that as a group do not meet the definition of a business, to counterparties that are not customers. Therefore, if the decrease in interest in the subsidiary is in substance a transaction within the scope of ASC 610-20, it would be outside the scope of ASC 810.

A reporting entity that transfers a nonfinancial asset or an ISNFA in the scope of ASC 610-20 follows a two-step derecognition model to determine whether (and when) to derecognize the asset as follows:

- ▶ Step 1: Apply the guidance in ASC 810 to determine whether the reporting entity has a controlling financial interest in the legal entity that holds the asset after the transaction
- ▶ Step 2: Apply certain guidance in ASC 606 to determine whether (and when) control transfers and how to measure the associated gain or loss

The FASB decided⁹⁵ that, even for a transaction in the scope of ASC 610-20, if a reporting entity continues to have a controlling financial interest in the legal entity that holds the asset after the transaction (i.e., it fails step 1), it accounts for the transaction as an equity transaction, the same as it would for a change in interest transaction without the loss of control that's in the scope of ASC 810. Therefore, if the reporting entity retains a controlling financial interest in the subsidiary, it does not derecognize the nonfinancial assets or ISNFAs transferred and accounts for the transaction as an equity transaction as described in section 18.4.

See sections 2 and 3 of our FRD, ***Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)*** for further guidance on the scope and the derecognition guidance in that standard, respectively.

18.3.2.2.6 ***Decrease in interest – substance not addressed by other GAAP***

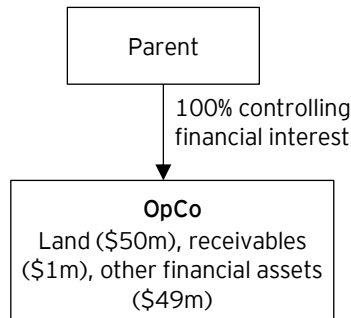
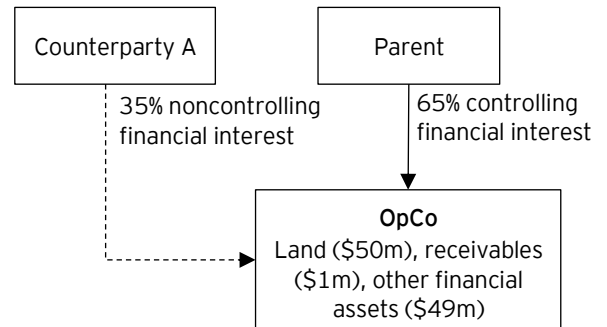
When a parent sells a noncontrolling interest in a subsidiary that is not a business or nonprofit activity and the substance of the transaction is not addressed by other GAAP, the parent accounts for the transaction as an equity transaction in the scope of ASC 810.

The following example illustrates how to apply the scoping guidance and the flowchart in section 18.3 to a transaction in which a parent sells a noncontrolling interest in an entity that is not a business, and the substance of the transaction is not addressed by other GAAP.

⁹⁵ Paragraph BC55 of ASU 2017-05.

Illustration 18-4: Partial sale of a consolidated entity that is not a business

Parent owns a 100% controlling interest in OpCo. OpCo holds land, receivables and other financial assets with fair values of \$50 million, \$1 million and \$49 million, respectively, and does not meet the definition of a business. Parent sells a 35% noncontrolling interest in OpCo to Counterparty A.

Before:**After:**

Parent evaluates all the assets promised in the contract and concludes that the transaction is not with a customer, so the transaction is not in the scope of ASC 606. Parent did not sell a noncontrolling interest in a business; therefore, the transaction is not in the scope of ASC 810-10-45-21A(b)(1). Parent determines that substantially all of the fair value of the assets promised in the contract (i.e., only 50%) is not concentrated in nonfinancial assets. As a result, the transaction is not in the scope of ASC 610-20.

The sale of the noncontrolling interest in OpCo is in the scope of ASC 810-10-45-21A(b)(2) unless other guidance addresses the substance of the transaction. In this fact pattern, Parent concludes that no other literature addresses the substance of the transaction. Therefore, the sale of the noncontrolling interest in OpCo would be in the scope of ASC 810-10-45-21A(b)(2). That is, Parent would not separate the nonfinancial assets from the financial assets but would instead account for the sale of the noncontrolling interest in OpCo as one unit of account in the scope of ASC 810.

18.3.3**Subsidiaries acquired before adoption of FAS 160 and FAS 141R**

We believe all subsequent acquisitions or dispositions of ownership interests in subsidiaries in transactions in the scope of ASC 810-10-45-21A while the parent maintains control, including those related to business combinations before the adoption of FAS 141(R), should be accounted for as equity transactions.

According to FAS 141(R), assets and liabilities that arose from business combinations whose acquisition dates preceded the effective date of FAS 141(R) should not be adjusted upon the adoption of FAS 141(R). Accordingly, acquisitions of the noncontrolling interest by the parent while it maintains its controlling financial interest should not be accounted for as step acquisitions. Similarly, a parent's sales of its ownership interests in a subsidiary in a transaction that is within the scope of ASC 810-10-45-21A when the parent continues to maintain control should be accounted for as equity transactions.

18.4 Accounting for changes in a parent's ownership interest in a subsidiary in a transaction within the scope of ASC 810

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

Changes in a Parent's Ownership Interest in a Subsidiary

810-10-45-23

Changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary shall be accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners). Therefore, no gain or loss shall be recognized in consolidated net income or comprehensive income. The carrying amount of the noncontrolling interest shall be adjusted to reflect the change in its ownership interest in the subsidiary. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent. Example 1 (paragraph 810-10-55-4B) illustrates the application of this guidance.

ASC 810 requires that transactions within its scope that increase or decrease a parent's ownership interest in a subsidiary be accounted for as equity transactions. That is, no purchase accounting adjustments are made.

If the transaction is in the scope of ASC 810-10-45-21A, the carrying amount of the noncontrolling interest should be adjusted to reflect the change in the noncontrolling interest's ownership in the subsidiary's net assets (that is, the ending noncontrolling interest should reflect its ownership of the subsidiary's net assets inclusive of any consideration received or paid by the subsidiary).

Any difference between (1) the fair value of the consideration received or paid (whether by the parent or the subsidiary) and (2) the adjustment made to the carrying amount of the noncontrolling interest should be recognized directly in equity (e.g., additional paid-in capital) and attributable to the controlling interest. No gain or loss is recognized.

See section 5.10 and C.4.2 of our FRD, *Issuer's accounting for debt and equity financings*, for additional guidance on accounting for redeemable noncontrolling interests in the scope of ASC 480-10-S99-3A.

Illustration 18-5: Parent increases its ownership interest in a subsidiary

Parent owns an 80% interest in Subsidiary, which has net assets of \$4,000. The carrying amount of the noncontrolling interest's 20% interest in Subsidiary is \$800. Parent acquires an additional 10% interest in Subsidiary from the noncontrolling interest holder for \$500, increasing its controlling interest to 90%.

Analysis

Assuming the transaction is in the scope of ASC 810, Parent would account for its increased ownership interest and decrease in the noncontrolling interest of \$400 ($\$4,000 \times 10\%$) in Subsidiary as an equity transaction as follows:

Stockholders' equity – noncontrolling interest	\$ 400	
Additional paid-in capital	100	
Cash		\$ 500

Illustration 18-6: Parent decreases its ownership interest by selling shares

Subsidiary A has 10,000 shares of common stock outstanding, all of which are owned by Parent. The carrying amount of Subsidiary A's equity is \$200,000. Parent sells 2,000 of its shares in Subsidiary A to an unrelated entity for \$50,000 cash, reducing its ownership interest to 80% from 100%. Assume the transaction is in the scope of ASC 810-10-45-21A(b).

Analysis

Parent would record noncontrolling interest of \$40,000 ($\$200,000 \times 20\%$). The excess of cash received over the carrying amount of the noncontrolling interest (\$10,000) is recorded as an increase to additional paid-in capital attributable to Parent as follows:

Cash	\$ 50,000	
Additional paid-in capital		\$ 10,000
Stockholders' equity – noncontrolling interest		40,000

Illustration 18-7: Parent decreases its ownership interest by causing subsidiary to issue new shares

Subsidiary A has 10,000 shares of common stock outstanding. Parent owns 9,000 of the outstanding shares and other shareholders own the remaining 1,000 shares. The carrying amount of Subsidiary A's equity is \$300,000, with \$270,000 attributable to Parent and \$30,000 attributable to the noncontrolling interest holders.

Assume Subsidiary A sells 2,000 previously unissued shares to an unrelated entity for \$120,000 cash, increasing the carrying amount of Subsidiary A's equity to \$420,000 ($\$300,000 + \$120,000$) and the total shares outstanding to 12,000. Assume the transaction is in the scope of ASC 810-10-45-21A(b).

Analysis

The carrying amount of the noncontrolling interest would increase to \$105,000 (25% (calculated as 3,000 shares / 12,000 shares) of \$420,000). This increase of \$75,000 ($\$105,000 - \$30,000$) would be recorded as:

Cash	\$ 120,000	
Additional paid-in capital		\$ 45,000
Stockholders' equity – noncontrolling interest		75,000

The ending carrying amount of the noncontrolling interest should equal its share of Subsidiary A's net assets.

18.4.1**Contingent consideration in an increase in interest**

An increase in a parent's ownership interest in a subsidiary may involve contingent consideration. For example, when acquiring an additional interest in a subsidiary, the parent may promise to deliver cash, additional equity interests or other assets to the seller after the acquisition date if certain specified events occur or conditions are met in the future. These contingencies frequently are based on future earnings or changes in the market price of the subsidiary's stock over specified periods after the date of the sale. However, they might be based on other factors (e.g., components of earnings, product development milestones, cash flow levels, successful completion of third-party contract negotiations).

The basis for recognition and measurement of contingent consideration is not addressed in ASC 810. Therefore, a parent should consider other guidance. If contingent consideration meets the definition of a derivative, it should be accounted for under ASC 815. If contingent consideration is not a derivative, the parent should evaluate the arrangement to determine if it represents payments to employees or selling shareholders that are compensatory. If the parent determines that the contingent payments are compensatory, the parent would not recognize a liability at the transaction date. Instead, the parent would recognize compensation expense for the arrangement based on other applicable GAAP (e.g., ASC 710-10-25-9). See section 6.4 of our FRD, *Business combinations*, for further guidance on evaluating whether contingent payments to employees or selling shareholders are compensatory.

When contingent consideration does not meet the definition of a derivative and is not compensatory, the Codification does not provide detailed guidance. In this circumstance, we believe the basis for recognition and measurement of contingent consideration payable by the parent is an accounting policy choice that should be applied on a consistent basis. One accounting policy applied in practice is to analogize to ASC 805. Other alternatives also may be acceptable.

Illustration 18-8: Accounting for contingent consideration for the acquisition of noncontrolling interests by analogizing to ASC 805

Parent currently owns 80% of Subsidiary A. Parent acquires the remaining 20% of Subsidiary A for an up-front cash payment plus a contingent cash payment based on Subsidiary A's cumulative EBITDA at the end of 3 years and the transaction is within the scope of ASC 810. The contingent consideration is not a derivative and is not compensatory. In this circumstance, Parent's accounting policy is to analogize to the contingent consideration guidance in ASC 805.

Analysis

Parent would record the contingent consideration liability at fair value at the acquisition date. Any subsequent changes in the fair value of the contingent consideration liability would be recognized in earnings.

18.4.2

Accumulated other comprehensive income considerations in a change in interest

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

Changes in a Parent's Ownership Interest in a Subsidiary

810-10-45-24

A change in a parent's ownership interest might occur in a subsidiary that has accumulated other comprehensive income. If that is the case, the carrying amount of accumulated other comprehensive income shall be adjusted to reflect the change in the ownership interest in the subsidiary through a corresponding charge or credit to equity attributable to the parent. Example 1, Case C (paragraph 810-10-55-4F) illustrates the application of this guidance.

A parent's ownership interest may change without losing control of a subsidiary that has accumulated other comprehensive income (AOCI). If the change in interest in the subsidiary is in the scope of ASC 810-10-45-21A, the AOCI balance is adjusted to reflect the change in the parent's ownership interest with a corresponding adjustment to equity (e.g., additional paid-in capital) attributable to the parent.

The following illustrations show how the guidance applies when there is AOCI related to a subsidiary in which there is a change in the noncontrolling interest in a transaction in the scope of ASC 810. See ASC 810-10-55-4F for another illustration.

Illustration 18-9: Accounting for AOCI when a parent's ownership interest increases

Parent owns an 80% interest in Subsidiary, which has net assets of \$4,000 and \$1,000 in AOCI. The carrying amount of the 20% noncontrolling interest in Subsidiary is \$800, which includes \$200 of its proportionate share of AOCI. Parent acquires an additional 10% interest in Subsidiary for \$500 from a third-party noncontrolling interest holder, increasing its ownership interest to 90% in a transaction that is within the scope of ASC 810-10-45-21A.

Analysis

As a result of this purchase, Parent's interest in Subsidiary's AOCI balance increases by \$100 (\$1,000 x 10%). Under ASC 810, Parent accounts for its increased ownership interest in Subsidiary as follows:

Stockholders' equity – noncontrolling interest	\$ 400	
Additional paid-in capital	200	
Cash		\$ 500
AOCI		100

Illustration 18-10: Accounting for AOCI when a parent's ownership interest decreases

Parent owns 100% of Subsidiary, which has net assets of \$4,000 and \$1,000 of AOCI. Parent sells a 10% interest in Subsidiary for \$500, decreasing its interest to 90% in a transaction that is within the scope of ASC 810-10-45-21A.

Analysis

As a result of the sale, Parent's interest in Subsidiary's AOCI balance decreases by \$100 (\$1,000 x 10%). Under ASC 810, Parent will account for the change in its ownership interest in Subsidiary as follows:

Cash	\$ 500	
AOCI	100	
Stockholders' equity – noncontrolling interest		\$ 400
Additional paid-in capital		200

18.4.2.1

Accounting for foreign currency translation adjustments

Excerpt from Accounting Standards Codification

Foreign Currency Matters – Translation of Financial Statements

Derecognition

Partial Sale of Ownership Interest

830-30-40-2

If a **reporting entity** sells part of its ownership interest in an equity method investment that is a foreign entity, a pro rata portion of the accumulated translation adjustment component of equity attributable to that equity method investment shall be recognized in measuring the gain or loss on the sale. If the sale of part of an equity method investment that is a foreign entity results in the loss of significant influence, see paragraphs 323-10-35-37 through 35-39 for guidance on how to account for the pro rata portion of the accumulated translation adjustment component of equity attributable to the remaining investment. For guidance if an entity sells a noncontrolling interest in a consolidated foreign entity, but still retains a controlling financial interest in the foreign entity, see paragraph 810-10-45-23 through 45-24.

If the sale of a noncontrolling interest in a consolidated foreign entity (or issuance of additional shares by the consolidated foreign entity) does not result in the parent losing control of the consolidated foreign entity, no amount of the related currency translation adjustment should be released and recognized in income. Instead, a pro-rata share of the currency translation adjustment should be reallocated between the controlling interest and the noncontrolling interest in accordance with ASC 810-10-45-23 through 24. This is the same as the accounting for other items in AOCI described in section 18.4.2.

ASC 810 and ASC 830 define a foreign entity as an operation (e.g., subsidiary, division, branch, joint venture, etc.) whose financial statements are both (a) prepared in a currency other than the reporting currency of the reporting entity and (b) combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity. Therefore, a foreign entity may differ from a legal entity as defined by the standards. See section 1.2.2 of our FRD, *Foreign currency matters*, for further guidance on the definition of a foreign entity.

18.4.3 Allocating goodwill upon a change in a parent's ownership interest

Although the total goodwill balance is not adjusted upon a change in parent's ownership interest in a subsidiary that does not result in a loss of control, for the purpose of testing goodwill for impairment, goodwill should be reallocated between the controlling and noncontrolling interests based on the changes in ownership interests. See section 3.15.2 or 3A.15.2 of our FRD, *Intangibles – goodwill and other*, for additional guidance and an example that includes a control premium.

Illustration 18-11: Allocating goodwill upon a change in a parent's ownership interest

Parent initially acquires 80% of Subsidiary. The business combination is accounted for under ASC 805 and \$100 of goodwill is recognized (\$80 attributable to Parent and \$20 attributable to the noncontrolling interest, assuming no control premium). Parent later acquires an additional 10% interest in Subsidiary.

Analysis

The consolidated amount of goodwill does not change, but the goodwill balance is reallocated between Parent and the noncontrolling interest based on the revised ownership interests for purposes of testing it for impairment. That is, \$90 would be attributable to Parent and \$10 would be attributable to the noncontrolling interest.

18.4.4 Accounting for transaction costs incurred upon a change in a parent's ownership interest

ASC 810 provides that gains or losses should not be recognized upon changes in a parent's ownership of a subsidiary while it retains control if the transaction is within the scope of ASC 810-10-45-21A. As stated in paragraph B44 of FAS 160, "the Board believes that accounting for transactions with noncontrolling owners as equity transactions follows logically from the conclusion that noncontrolling owners have an ownership interest in the consolidated entity." We believe these transactions are analogous to treasury stock transactions.

Based on this, we believe that specific, direct and incremental costs (but not management salaries or other general and administrative expenses) related to changes in a parent's ownership percentage when control is maintained may be accounted for as part of the equity transaction when the transaction is in the scope of ASC 810. However, the guidance in ASC 810-10-40-6 (discussed in section 19.2.1) that addresses whether multiple arrangements should be accounted for as a single transaction also should be considered.

We note that some practitioners believe that transaction costs incurred in connection with changes in ownership of consolidated subsidiaries meeting the scope of ASC 810-10-45-21A while control is retained are not analogous to treasury stock transactions and, therefore, should be expensed as incurred. We believe that until further guidance is issued, a reporting entity should adopt and consistently apply an accounting policy for these costs. See section 23.3.4.1 for further guidance on presentation of transaction costs in the statement of cash flows.

18.4.5 Income tax considerations

See section 12.2 of our FRD, *Income taxes*, for discussion of income tax considerations related to a change in ownership interest in a subsidiary that does not result in a loss of control.

18.5 Other decrease in ownership transactions without a loss of control (added August 2022)

This section addresses accounting considerations for other decreases in ownership transaction without a loss of control. Such transactions include:

- ▶ Issuance of a stock option by a subsidiary (section 18.5.1)
- ▶ Issuance of preferred stock by a subsidiary (section 18.5.2)
- ▶ Issuance of partnership units with varying profit or liquidation preferences by a subsidiary (section 18.5.3)
- ▶ Issuance of subsidiary shares as consideration in a business combination (section 18.5.4)
- ▶ Issuance of subsidiary shares in a common control transaction (section 18.5.5)

18.5.1 Issuance of a stock option by a subsidiary

A subsidiary may grant a share-based payment award of its own stock to its employees that would result in a decrease in the parent's ownership interest and an increase in the noncontrolling interest when exercised. As the options vest, the parent may recognize the share-based payment expense with a corresponding increase in the noncontrolling interest in the consolidated financial statements. Other alternatives may also be acceptable for recognizing the credit within equity. This accounting does not affect the attribution of net income (which includes share-based payment compensation expense) between the controlling and noncontrolling interest.

Awards of this nature may arise in a business combination when the acquirer is not obligated to replace the acquiree's awards and the awards continue to exist after the transaction. The accounting for these awards is addressed in section 6.3.2.3 of our FRD, *Business combinations*.

18.5.2 Issuance or redemption of preferred stock by a subsidiary

Excerpt from Accounting Standards Codification

Consolidation – Overall

Derecognition

810-10-40-1

Accounting for the purchase (early extinguishment) of a wholly owned **subsidiary's** mandatorily redeemable preferred stock, including stock that contains a redemption feature but is not considered a mandatorily redeemable financial instrument under Topic 480, differs dependent on whether the preferred stock is required under Topic 480 to be accounted for as a liability.

810-10-40-2

Section 480-10-25 does not require mandatorily redeemable preferred stock to be accounted for as a liability under certain conditions. If such conditions apply and the mandatorily redeemable preferred stock is not accounted for as a liability, then the entity's acquisition of a subsidiary's mandatorily redeemable preferred stock shall be accounted for as a capital stock transaction. Accordingly, the consolidated entity would not recognize in its income statement any gain or loss from the acquisition of the subsidiary's preferred stock. In the **consolidated financial statements**, the dividends on a subsidiary's preferred stock, whether mandatorily redeemable or not, would be included in noncontrolling interest as a charge against income.

810-10-40-2A

Section 480-10-25 requires mandatorily redeemable preferred stock to be accounted for as a liability under certain conditions. If mandatorily redeemable preferred stock is accounted for as a liability, then any amounts paid or to be paid to holders of those contracts in excess of the initial measurement amount are reflected as interest cost and not as **noncontrolling interest** charge. Topic 860 specifies whether a liability has been extinguished and Subtopic 470-50 requires that the **parent** recognize a gain or loss upon extinguishment of the subsidiary's liability for mandatorily redeemable preferred shares for any difference between the carrying amount and the redemption amount.

Under ASC 810-10-45-23, a change in a parent's ownership interest while the parent retains control of the subsidiary that is in the scope of ASC 810 is accounted for as an equity transaction. We believe that the preferred stock issuance by a subsidiary to noncontrolling interest holders generally should be reflected as a noncontrolling interest in the financial statements of the parent at the amount of the cash proceeds received (e.g., the par amount) when it does not represent a residual equity interest.

The holders of preferred stock often are entitled to a liquidation preference amount, which generally includes a par amount and, in some cases, cumulative unpaid dividends. Preferred stockholders of a subsidiary also are typically entitled to a share of the subsidiary's earnings up to the stated dividend. Unlike an issuance of common stock by a subsidiary (which generally results in a change in the parent's ownership interest), the issuance of preferred stock by a subsidiary does not change the parent's residual ownership interest. When a parent recognizes the issuance of preferred stock by a subsidiary that is not a residual interest, we believe there should not be an adjustment to the parent's equity accounts. (See section 16.1.3 for interpretive guidance on attributions to noncontrolling interests held by preferred shareholders.)

Similarly, an entity's acquisition of outstanding equity-classified preferred stock (e.g., a redemption) is accounted for as an equity transaction and no gain or loss is recognized. See section 3.5.1.3 of our FRD, ***Issuer's accounting for debt and equity financings***, for additional guidance on the repurchase of redeemable shares issued by a wholly owned subsidiary. See section 3.2.1 of our FRD, ***Earnings per share***, for guidance on the effect on earnings per share upon a redemption or induced conversion of preferred stock.

18.5.3**Issuance by a subsidiary of partnership units that have varying profit or liquidation preferences**

Pursuant to ASC 810-10-45-23, changes in a parent's ownership interest while the parent retains control of a subsidiary that is in the scope of ASC 810 should be accounted for as equity transactions.

For entities structured as partnerships, often there is a substantive profit-sharing arrangement that specifies how to allocate profits to the partners. In some cases, the profit-sharing arrangement provides certain partners with preferential returns from operations or a liquidation preference.

If a subsidiary issues partnership units that represent preferential returns, we believe that the parent should reflect those units as noncontrolling interest in its financial statements at the amount of cash proceeds received with no adjustment to the parent's equity accounts. This is consistent with the guidance for the issuance of preferred stock by a subsidiary that is not a residual interest (see section 18.5.2). Alternatively, if partnership units are issued without preferences, we believe that the parent of the partnership would follow the guidance in ASC 810-10-45-23. See section 18.5.3.1 for further guidance.

(See section 16.1.3 for interpretive guidance on attributions to noncontrolling interests held by preferred shareholders).

18.5.3.1

Issuance of preferential limited partnership units by a Master Limited Partnership account

A Master Limited Partnership (MLP) is a limited partnership whose units are available to investors and traded on public exchanges, just like corporate stock. MLPs usually involve (1) a general partner (GP), who typically holds a small percentage (commonly 2%) of the outstanding partnership units and manages the operations of the partnership, and (2) limited partners (LPs), who provide capital and hold most of the ownership but have limited influence over the operations. Reporting entities that form MLPs typically do so to take advantage of the special tax treatment of the partnership structure (although MLPs may also provide an attractive exit strategy for owners of private equity assets). To qualify for the tax benefits, 90% of an MLP's income must be derived from activities in natural resources, real estate or commodities. As a result, the energy industry has experienced a dramatic rise in the use of the MLP structure. The GP frequently consolidates the MLP, but this conclusion depends on the facts and circumstance and should be evaluated carefully.

Issuance of limited partnership units

For the issuance of LP interests, all sales first should be evaluated to determine whether they are in the scope of other US GAAP. Assuming the sale is not in the scope of other US GAAP, a consolidated subsidiary that issues shares while the parent maintains control of the subsidiary should be accounted for as a capital transaction pursuant to the decrease-in-ownership guidance in ASC 810.

However, the decrease-in-ownership guidance may not apply when an MLP issues limited partnership units that have a preference in distributions or liquidation rights (referred to as the common LP units). It is common for an MLP partnership agreement to provide that, during a subordination period, the common LP units will have the right to receive distributions of available cash each quarter based on a minimum quarterly distribution, plus any arrearages, before any distributions of available cash may be made on the subordinated LP units. Furthermore, no arrearages will be paid on the subordinated units.

The practical effect of the subordinated LP units is to increase the likelihood that during the subordination period there will be available cash to be distributed on the common LP units. When subordinated LP units are held by the parent/GP of an MLP, common LP units do not possess the characteristics of a residual equity interest given the common LP units' preference over the subordinated LP units. We believe that the accounting guidance related to changes in a parent's ownership interest in a subsidiary would not apply. Therefore, if the parent/GP owns subordinated LP units in the MLP, the parent/GP should reflect the proceeds from issuance of common LP units as noncontrolling interest in its financial statements with no adjustment to additional paid-in capital. We believe that if the class of security issued by the subsidiary has a preference in distribution or liquidation rights over any other class of equity security, it is analogous to preferred stock. As such, we believe the guidance in ASC 810-10-45-23 would not apply to such transactions. See section 18.5.2 above for additional discussion.

Expiration of subordination period

MLP partnership agreements include provisions for the subordination period to expire after a specific period of time if the minimum quarterly distributions have been made to the holders of the common LP units. Upon the expiration of the subordination period, all subordinated LP units held by the parent/GP have the same distribution and liquidation rights as the other common LP units. Although the common LP units previously issued by the MLP to the holders of the noncontrolling interest no longer have a preference in distributions due to the expiration of the subordination period, we believe this loss of preference has no immediate accounting consequences. The accounting for changes in noncontrolling interests applies only to changes in a parent's ownership interest in a subsidiary, which includes circumstances in which, "(a) the parent purchases additional ownership interests in its subsidiary, (b) the parent sells some of its ownership interests in its subsidiary, (c) the subsidiary reacquires some of its ownership interests, or (d) the subsidiary issues additional ownership interests" (ASC 810-10-45-22). We believe the expiration of the subordination period is not a change in the parent's ownership interest in a subsidiary because the expiration does not result in a change in ownership interest in the MLP. As such, there is no adjustment to be recognized to the equity accounts of the parent (that is, no adjustment to additional paid-in capital) or noncontrolling interest as a result of the expiration of the preferences.

18.5.4 Issuance of subsidiary shares as consideration in a business combination

See section 6.1.2.2 of our FRD, *Business combinations*, for a discussion of the accounting when an acquirer issues subsidiary shares as consideration for a controlling interest in another entity that is a business.

18.5.5 Noncontrolling interests in a common control transaction

See section C.4.3 of our FRD, *Business combinations*, for discussion of the accounting for any changes in noncontrolling interests from a combination of entities under common control that does not result in a loss of control.

18.6 Examples of changes in a parent's ownership interest when the parent maintains control of a subsidiary in a transaction in the scope of ASC 810

The following examples illustrate the accounting in consolidation for changes in a parent's ownership interest when the parent maintains control of a subsidiary in a transaction that is in the scope of ASC 810-10-45-21A. Workpaper adjusting entries are numbered sequentially.

While there are different ways to apply consolidation procedures, these examples illustrate consolidation based on pushdown accounting to the subsidiary (with the exception that certain elimination entries have not been pushed back to the parent or subsidiary columns, as might otherwise be appropriate for the external reporting of consolidating financial statements – see section 22 for more information).

Illustration 18-12: Accounting for initial acquisition

On 1 January 20X1, Company P, which is newly formed, raises \$45,000 of capital by issuing 1,500 shares of \$1 par stock for \$36,000 and issuing \$9,000 of debt. Company P uses this capital to acquire 70% of stock of Company S for \$45,000. Company S qualifies as a business under ASC 805 and its full fair value is \$64,286 ($\$45,000/70\%$), assuming no control premium. The noncontrolling interest in Company S is measured at its acquisition-date fair value of \$19,286, which is assumed to be 30% of the full fair value of Company S ($\$64,286$). Company S's acquisition-date balance sheet is presented in Figure 18-1. Income taxes have been ignored.

This example includes certain assumptions for simplicity that are not common in practice. For example, it would be unusual for no identifiable intangible assets to be recognized as part of the business combination (and for all the excess purchase price to be allocated to goodwill). Additionally, this example assumes there is no control premium.

Figure 18-1: Acquisition-date balance sheet for Company S at 1 January 20X1 (all amounts in dollars)

	<u>Book value</u>	<u>Fair Value</u>
Cash	3,000	3,000
Marketable securities	12,000	12,000
Inventory	30,000	34,500
Buildings and equipment, net	<u>60,000</u>	<u>85,500</u>
	<u>105,000</u>	<u>135,000</u>
Accounts payable	75,000	75,000
Common stock	25,000	
Retained earnings	<u>5,000</u>	
	<u>105,000</u>	

18.6.1

Consolidation at the acquisition date

ASC 805 generally requires the acquirer to measure the identifiable assets acquired, the liabilities assumed and noncontrolling interest in the acquiree at their acquisition-date fair values if the acquiree meets the definition of a business under ASC 805. While Company S is not a VIE in this example, it's important to note that the initial consolidation of a VIE that is a business is a business combination and also is accounted for in accordance with the provisions in ASC 805, as discussed in section 13.3.

Illustration 18-13: Consolidation at the acquisition date

The consolidation procedures illustrated in this example reflect the revaluation of the subsidiary's assets and liabilities on the subsidiary's financial statements. That is, this example assumes pushdown accounting has been applied pursuant to ASC 805.

Figure 18-2: Acquisition-date consolidating workpaper to arrive at consolidated balance sheet, 1 January 20X1 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Cash	-	3,000			3,000
Marketable securities	-	12,000			12,000
Inventory	-	(1) 34,500			34,500
Buildings and equipment, net	-	(2) 85,500			85,500
Investment in Company S	45,000	-	(5)	45,000	-
Goodwill	-	(3) 4,286			4,286
Total assets	<u>45,000</u>	<u>139,286</u>			<u>139,286</u>
Accounts payable	-	75,000			75,000
Debt	9,000	-			9,000
Total liabilities	<u>9,000</u>	<u>75,000</u>			<u>84,000</u>
Common stock	1,500	25,000	(6) 25,000		1,500
Additional paid-in capital	34,500	(4) 39,286	(6) 39,286		34,500
Accumulated other comprehensive income	-	-			-
Retained earnings	-	-			-
Total parent shareholders' equity	<u>36,000</u>	<u>64,286</u>			<u>36,000</u>
Noncontrolling interest	-	-		(7) 19,286	19,286
Total equity	<u>36,000</u>	<u>64,286</u>			<u>55,286</u>
Total liabilities and equity	<u>45,000</u>	<u>139,286</u>			<u>139,286</u>

Figure 18-2 illustrates the elimination of Company P's investment in Company S and allocation of the purchase price (\$45,000) to the acquired assets, liabilities and noncontrolling interest, as follows:

- (1) Inventory is measured at fair value.
- (2) Buildings and equipment are measured at fair value.
- (3) Goodwill is determined by subtracting the fair value of Company S's net identifiable assets (\$60,000) from the sum of the fair values of the consideration paid (\$45,000) and the noncontrolling interest (\$19,286).
- (4) In pushdown accounting, the Company S's books are adjusted to fair value, retained earnings are eliminated and the balance is added to APIC. The amount of \$39,286 represents the net of the fair value adjustments to inventory, buildings and equipment and goodwill and the elimination of retained earnings.
- (5) Company P's investment in Company S is eliminated.
- (6) Company S's common stock and additional paid-in capital accounts are eliminated.
- (7) Noncontrolling interest is measured at its acquisition-date fair value.

18.6.2

Consolidation in year of combination

Illustration 18-14: Consolidation in year of combination

On 31 December 20X1, the fair value of Company S's marketable securities is \$17,000.

Company S's income statement for the year ended 31 December 20X1 is shown in Figure 18-4. For illustrative purposes, Company S's income statement has been made constant for each year of this example. Net income is attributed based on outstanding voting interests.

Figure 18-3: Income statement for Company S for each year (all amounts in dollars)

Revenues	96,000
Cost of revenues	<u>42,000</u>
Gross profit	54,000
Selling and administrative (including 6,000 of depreciation)	<u>24,000</u>
Net income	<u>30,000</u>

Figure 18-4: Consolidating worksheet to arrive at consolidated income statement, year of combination, 31 December 20X1 (all amounts in dollars)

	Company P	Company S	Adjustments		Consolidated
			Debit	Credit	
Revenues	-	96,000			96,000
Cost of revenues	-	42,000			42,000
Gross profit	-	54,000			54,000
Income from Investment in Company S	21,000	-	(8)	21,000	-
Selling and administrative	-	24,000			24,000
Net income	<u>21,000</u>	<u>30,000</u>			<u>30,000</u>
Net income attributable to noncontrolling interest	-	-	(9)	9,000	9,000
Net income attributable to controlling interest	21,000	30,000			21,000

- (8) Income from Investment in Company S recognized by Company P (\$30,000 x 70%) is eliminated.
- (9) Net income attributable to the controlling and noncontrolling interests is \$21,000 (\$30,000 x 70%) and \$9,000 (\$30,000 x 30%), respectively.

Figure 18-5: Consolidating workpaper to arrive at consolidated balance sheet, year of combination, 31 December 20X1 (all amounts in dollars)

	Company P		Company S		Adjustments		Consolidated
					Debit	Credit	
Cash	-		33,000				33,000
Marketable securities	-		17,000				17,000
Inventory	-		34,500				34,500
Buildings and equipment, net	-		85,500				85,500
Investment in Company S	(10)	69,500	-		(13)	69,500	-
Goodwill	-		4,286				4,286
Total assets		<u>69,500</u>	<u>174,286</u>				<u>174,286</u>
Accounts payable		-	75,000				75,000
Debt		9,000	-				9,000
Total liabilities		9,000	75,000				84,000
Common stock		1,500	25,000	(14)	25,000		1,500
Additional paid-in capital		34,500	39,286	(15)	39,286		34,500
Accumulated other comprehensive income	(11)	3,500	5,000	(16)	5,000		3,500
Retained earnings (deficit)	(12)	21,000	30,000	(17)	30,000		21,000
Total parent shareholders' equity		60,500	99,286				60,500
Noncontrolling interest		-	-		(18)	29,786	29,786
Total equity		60,500	99,286				90,286
Total liabilities and equity		<u>69,500</u>	<u>174,286</u>				<u>174,286</u>

Figure 18-5 presents a consolidating workpaper, which includes the following adjustments to arrive at the 31 December 20X1 consolidated balance sheet:

Note: For illustrative purposes, Company S's balance sheet does not reflect adjustments for depreciation and other changes likely to occur in practice. Therefore, Company S's cash balance is adjusted in order for the balance sheet to balance.

(10) A rollforward of Company P's investment is as follows:

Beginning balance	\$ 45,000
Attributed earnings from Company S	<u>21,000</u>
Attributed other comprehensive income from Company S (\$5,000 x 70%)	<u>3,500</u>
Ending balance	<u>\$ 69,500</u>

(11) Company P records its proportionate share of Company S's accumulated other comprehensive income balance (\$5,000 x 70%) with a corresponding adjustment to its investment.

(12) A rollforward of Company P's retained earnings is as follows:

Beginning balance	\$ -
Current year earnings of Company P (attributed earnings from Company S)	<u>21,000</u>
Ending balance	<u>\$ 21,000</u>

(13) Company P's investment in Company S is eliminated.

(14) Company S's common stock is eliminated.

(15) The additional paid-in capital of Company S is eliminated.

(16) The accumulated other comprehensive income of Company S is eliminated.

(17) The retained earnings of Company S are eliminated.

(18) Noncontrolling interest is recognized at its initial balance of \$19,286 plus its proportionate share of income from Company S of \$9,000 (see note 9) plus its proportionate share of other comprehensive income of \$1,500 (\$5,000 x 30%). The amount also represents 30% of Company S's total equity (\$29,786 = \$99,286 x 30%).

18.6.3

Consolidation after parent purchases an additional interest

Illustration 18-15: Consolidation after parent purchases an additional interest

On 1 January 20X2, Company P borrows \$39,000 and uses that cash to purchase outstanding shares of Company S for an additional 20% interest, increasing its ownership interest to 90%. (Note: This illustration does not account for interest expense on the loan).

Figure 18-6: Consolidating workpaper to arrive at consolidated balance sheet, 1 January 20X2
(all amounts in dollars)

			Adjustments		Consolidated
	Company P	Company S	Debit	Credit	
Cash	-	33,000			33,000
Marketable securities	-	17,000			17,000
Inventory	-	34,500			34,500
Buildings and equipment, net	-	85,500			85,500
Investment in Company S	(19) 89,357	-		(23) 89,357	-
Goodwill	-	4,286			4,286
Total assets	89,357	174,286			174,286
Accounts payable	-	75,000			75,000
Debt	(20) 48,000	-			48,000
Total liabilities	48,000	75,000			123,000
Common stock	1,500	25,000	(24) 25,000		1,500
Additional paid-in capital	(21) 14,357	39,286	(25) 39,286		14,357
Accumulated other comprehensive income	(22) 4,500	5,000	(26) 5,000		4,500
Retained earnings (deficit)	21,000	30,000	(27) 30,000		21,000
Total parent shareholders' equity	41,357	99,286			41,357
Noncontrolling interest	-	-		(28) 9,929	9,929
Total equity	41,357	99,286			51,286
Total liabilities and equity	89,357	174,286			174,286

- (19) Company P's investment balance represents 90% of Company S's total equity (\$99,286 x 90%).
- (20) Company P incurred additional debt of \$39,000 to fund the purchase of the additional interest in Company S, resulting in a balance of \$48,000 (\$9,000 + \$39,000).
- (21) APIC of Company P is reduced by \$20,143, resulting in a balance of \$14,357 (see journal entries below).
- (22) AOCI of Company P is increased by \$1,000 from \$3,500 to \$4,500 to reflect the portion of the AOCI that was purchased from the noncontrolling interest and is now attributable to Company P of \$1,000 (\$5,000 x 20%).

The entries recorded by Company P for this transaction are as follows:

Cash	\$	39,000	
Debt			\$ 39,000
Investment in Company S	\$	19,857	
APIC		20,143	
Cash			\$ 39,000
AOCI			1,000

- (23) Company P's investment in Company S is eliminated.
- (24) Company S's common stock is eliminated.

- (25) The additional paid-in capital of Company S is eliminated.
- (26) The accumulated other comprehensive income of Company S is eliminated.
- (27) The retained earnings of Company S are eliminated.
- (28) Noncontrolling interest represents 10% of Company S's total equity ($\$9,929 = \$99,286 \times 10\%$). The 31 December 20X1 balance for noncontrolling interest of Company S was $\$29,786$ (see Figure 18-5). This amount represented a 30% interest in Company S. Company P purchased an additional 20% interest in Company S from the noncontrolling interest holders, which was equivalent to two-thirds of this balance ($\$29,786 \times 2/3 = \$19,857$). Accordingly, the noncontrolling interest balance is reduced by $\$19,857$ resulting in a balance of $\$9,929$ ($\$29,786 - \$19,857$).

18.6.4

Consolidation after parent sells a portion of its interest

Illustration 18-16: Consolidation after parent sells a portion of its interest

Using the same balance sheets for Company P and Company S the year ended 31 December 20X1 as shown in Figure 18-5, assume that the Parent sells an additional 10% interest to a third party for $\$15,000$, reducing its ownership interest from 70% to 60%. The sale is in the scope of ASC 810-10-45-21A(b).

Figure 18-7: Consolidating workpaper to arrive at consolidated balance sheet, 1 January 20X2
(all amounts in dollars)

	Company P		Company S		Adjustments		Consolidated
					Debit	Credit	
Cash	(30)	15,000		33,000			48,000
Marketable securities		-		17,000			17,000
Inventory		-		34,500			34,500
Buildings and equipment, net		-		85,500			85,500
Investment in Company S	(29)	59,572		-	(33)	59,572	-
Goodwill		-		4,286			4,286
Total assets		<u>74,572</u>		<u>174,286</u>			<u>189,286</u>
Accounts payable		-		75,000			75,000
Debt		9,000		-			9,000
Total liabilities		<u>9,000</u>		<u>75,000</u>			<u>84,000</u>
Common stock		1,500		25,000	(34)	25,000	1,500
Additional paid-in capital	(31)	40,072		39,286	(35)	39,286	40,072
Accumulated other comprehensive income	(32)	3,000		5,000	(36)	5,000	3,000
Retained earnings (deficit)		21,000		30,000	(37)	30,000	21,000
Total parent shareholders' equity		<u>65,572</u>		<u>99,286</u>			<u>65,572</u>
Noncontrolling interest		-		-	(38)	39,714	39,714
Total equity		<u>65,572</u>		<u>99,286</u>			<u>105,286</u>
Total liabilities and equity		<u>74,572</u>		<u>174,286</u>			<u>189,286</u>

- (29) Company P's investment balance represents 60% of Company S's total equity ($\$99,286 \times 60\%$).
- (30) Company P received $\$15,000$ cash for selling its 10% interest in Company S.
- (31) APIC of Company P increased by $\$5,572$ (adjusted for rounding), resulting in a balance of $\$40,072$ (see journal entries below).
- (32) AOCI of Company P decreased by $\$500$ from $\$3,500$ to $\$3,000$ to reflect the portion of the AOCI that was sold to a third party and is now attributable to the noncontrolling interest ($\$5,000$ total AOCI \times 10% sold to third party).

The entries recorded by Company P for this transaction are as follows:

Cash	\$	15,000		
Investment in Company S			\$	9,929
APIC				5,071
AOCI	\$	500		
APIC			\$	500

- (33) Company P's investment in Company S is eliminated.
(34) Company S's common stock is eliminated.
(35) The additional paid-in capital of Company S is eliminated.
(36) The accumulated other comprehensive income of Company S is eliminated.
(37) The retained earnings of Company S are eliminated.
(38) Noncontrolling interest represents 40% of Company S's total equity (\$39,714 = \$99,286 x 40%). The 31 December 20X1 balance for noncontrolling interest of Company S was \$29,786 (see Figure 18-5).

See also ASC 810-10-55-4C for an illustration of the initial recognition of a noncontrolling interest.

18.6.5

Consolidation after subsidiary issues additional shares

Illustration 18-17: Consolidation after subsidiary issues additional shares

Using the same balance sheets for Company P and Company S for the year ended 31 December 20X1 as shown in Figure 18-5 (Company S has 25,000 shares outstanding at \$1 par), assume that Company S issues to a third party an additional 5,000 shares (\$1 par) for \$18,000 cash. As a result, Company P's ownership interest is diluted from 70% to 58% (17,500 shares / 30,000 shares). The issuance is in the scope of ASC 810-10-45-21A(b).

Figure 18-8: Consolidating workpaper to arrive at consolidated balance sheet, 1 January 20X2 (all amounts in dollars)

	Company P		Company S		Adjustments		Consolidated
					Debit	Credit	
Cash	-	(39)	51,000				51,000
Marketable securities	-		17,000				17,000
Inventory	-		34,500				34,500
Buildings and equipment, net	-		85,500				85,500
Investment in Company S	(40)	68,417	-		(43)	68,417	-
Goodwill		-	4,286				4,286
Total assets		<u>68,417</u>	<u>192,286</u>				<u>192,286</u>
Accounts payable		-	75,000				75,000
Debt		9,000	-				9,000
Total liabilities		9,000	75,000				84,000
Common stock		1,500	(39)	30,000	(44)	30,000	1,500
Additional paid-in capital	(41)	34,000	(39)	52,286	(45)	52,286	34,000
Accumulated other comprehensive income	(42)	2,917		5,000	(46)	5,000	2,917
Retained earnings (deficit)		21,000		30,000	(47)	30,000	21,000
Total parent shareholders' equity		<u>59,417</u>		<u>117,286</u>			<u>59,417</u>
Noncontrolling interest		-		-		(48)	48,869
Total equity		<u>59,417</u>		<u>117,286</u>			<u>108,286</u>
Total liabilities and equity		<u>68,417</u>		<u>192,286</u>			<u>192,286</u>

(39) Company S records the sale of shares as follows:

Cash	\$	18,000	
Common stock			\$ 5,000
APIC			13,000

(40) Company P's investment balance represents 58% of Company S's total equity (\$117,286 x 58%). Company P reduces its investment balance by \$1,083 (\$69,500 to \$68,417 with a corresponding adjustment to additional paid-in capital (see journal entries below).

(41) APIC of Company P is reduced by \$500, resulting in a balance of \$34,000 (see journal entries below).

(42) AOCI of Company P is decreased from \$3,500 to \$2,917 (\$5,000 x 58%). Company P reduces its AOCI balance by \$583 with a corresponding adjustment to APIC (see journal entries below).

The entries recorded by Company P for this transaction are as follows:

APIC	\$	1,083	
Investment in Company S			\$ 1,083
AOCI	\$	583	
APIC			\$ 583

(43) Company P's investment in Company S is eliminated.

(44) Company S's common stock is eliminated.

(45) The additional paid-in capital of Company S is eliminated.

(46) The accumulated other comprehensive income of Company S is eliminated.

(47) The retained earnings of Company S are eliminated.

(48) Noncontrolling interest represents 42% of Company S's total equity (\$48,869 = \$117,286 x 42%). The 31 December 20X1 balance for noncontrolling interest of Company S was \$29,786 (see Figure 18-5). This amount represented a 30% interest in Company S (or 7,500 shares). Company S issued an additional 5,000 shares to the noncontrolling interest holders, increasing their ownership percentage to 42% (12,500 / 30,000). Accordingly, the noncontrolling interest increased by \$19,083 (\$18,000 paid-in capital from the issuance of shares to noncontrolling interest holders plus \$1,083, which is the noncontrolling interest's increase in its share in net assets (see note 40)).

See also ASC 810-10-55-4D through 4E for an illustration in which the noncontrolling interest increases.

18.6.6

Consolidation after subsidiary acquires outstanding shares from noncontrolling interest holder

Illustration 18-18: Consolidation after subsidiary acquires outstanding shares from noncontrolling interest holder

Using the same balance sheets for Company P and Company S for the year ended 31 December 20X1 as shown in Figure 18-5, Company S has 25,000 shares outstanding at \$1 par (of which Company P owns 17,500 shares and the noncontrolling interest holder owns 7,500 shares), or 70% and 30%, respectively,

Company S repurchases 5,000 shares (\$1 par) to hold in treasury from a noncontrolling interest holder for \$35,000, which represents the fair value of the shares on 1 January 20X2. This transaction reduces the shares outstanding to 20,000 (25,000 – 5,000) and the noncontrolling interest to 2,500 shares outstanding (7,500 – 5,000). As a result, Company P's ownership interest increases from 70% to 87.5% (17,500 shares / 20,000 shares) and the noncontrolling interest decreases to 12.5% (2,500 shares / 20,000 shares). Company S borrowed \$5,000 to fund the share repurchase. The repurchase is in the scope of ASC 810-10-45-21A(a).

Figure 18-9: Consolidating workpaper to arrive at consolidated balance sheet, 1 January 20X2 (all amounts in dollars)

	Company P		Company S		Adjustments		Consolidated
					Debit	Credit	
Cash	-	(49), (50)	3,000				3,000
Marketable securities	-		17,000				17,000
Inventory	-		34,500				34,500
Buildings and equipment, net	-		85,500				85,500
Investment in Company S	(51)	56,250	-		(54)	56,250	-
Goodwill		-	4,286				4,286
Total assets		56,250	144,286				144,286
Accounts payable		-	75,000				75,000
Debt		9,000	(49) 5,000				14,000
Total liabilities		9,000	80,000				89,000
Common stock		1,500	25,000	(55)	25,000		1,500
Additional paid-in capital	(53)	20,375	39,286	(55)	39,286		20,375
Accumulated other comprehensive income	(52)	4,375	5,000	(55)	5,000		4,375
Retained earnings (deficit)		21,000	30,000	(55)	30,000		21,000
Treasury stock		-	(50) (35,000)	(55)	(35,000)		-
Total parent shareholders' equity		47,250	64,286				47,250
Noncontrolling interest		-	-		(56)	8,036	8,036
Total equity		47,250	64,286				55,286
Total liabilities and equity		56,250	144,286				144,286

(49) Company S borrowed \$5,000 to fund the share repurchase and recorded the loan as follows:

Cash	\$	5,000	
Debt			\$ 5,000

(50) Company S recorded the acquisition of its shares as follows:

Treasury stock	\$	35,000	
Cash			\$ 35,000

- (51) Investment in Company S (held by Company P) decreases by \$13,250 (\$69,500 at 31 December 20X1 to \$56,250), to reflect the increase in Company S's total equity attributable to Company P ($\$56,250 = \$64,286 \times 87.5\%$) (see journal entry 53 below). In this calculation, \$64,286 is the total equity of Company S.
- (52) AOCI of Company P increases by \$875 from \$3,500 at 31 December 20X1 to \$4,375 ($\$5,000 \times 87.5\%$) to reflect the increase in AOCI attributable to Company P (see journal entry 53 below).
- (53) APIC of Company P decreases by \$14,125 as a result of the credits to the Investment in Company S and AOCI, as described in journal entries 51 and 52, respectively, resulting in a balance of \$20,375.

The entry recorded by Company P for this transaction is as follows:

APIC	\$ 14,125	
Investment in Company S		\$ 13,250
AOCI		875

- (54) Company P's investment in Company S is eliminated.
- (55) Company S's common stock, APIC, AOCI, retained earnings and treasury stock are eliminated.
- (56) Noncontrolling interest represents 12.5% of Company S's total equity ($\$8,036 = 12.5\% \times \$64,286$). The 31 December 20X1 noncontrolling interest of Company S was \$29,786 (see Figure 18-5). Accordingly, the noncontrolling interest decreased by \$21,750 resulting in a balance of \$8,036 ($\$29,786 - \$21,750$).

19 Loss of control over a subsidiary or a group of assets

19.1 Introduction (added August 2022)

A parent deconsolidates a subsidiary or derecognizes a group of assets in a transaction that is in the scope of ASC 810-10-40-3A when that parent no longer has a controlling financial interest in the subsidiary or group of assets. Upon a loss of control, the parent derecognizes the assets, liabilities and components of equity (including any noncontrolling interest) in its consolidated financial statements. A gain or loss is recognized, and any retained noncontrolling investment is measured at fair value.

The accounting for a loss of control transaction involves three key steps:

- ▶ Determining whether the parent lost control (see section 19.2)
- ▶ Determining whether the transaction is within the scope of ASC 810 (see section 19.3)
- ▶ Determining the gain or loss (see section 19.4)

19.2 Losing a controlling financial interest

Excerpt from Accounting Standards Codification

Consolidation – Overall

810-10-40-4

A parent shall deconsolidate a subsidiary or derecognize a group of assets specified in paragraph 810-10-40-3A as of the date the parent ceases to have a controlling financial interest in that subsidiary or group of assets. See paragraph 810-10-55-4A for related implementation guidance.

Implementation Guidance and Illustrations

810-10-55-4A

All of the following are circumstances that result in deconsolidation of a subsidiary under paragraph 810-10-40-4:

- a. A parent sells all or part of its ownership interest in its subsidiary and, as a result, the parent no longer has a controlling financial interest in the subsidiary.
- b. The expiration of a contractual agreement that gave control of the subsidiary to the parent.
- c. The subsidiary issues shares, which reduces the parent's ownership interest in the subsidiary so that the parent no longer has a controlling financial interest in the subsidiary.
- d. The subsidiary becomes subject to the control of a government, court, administrator, or regulator.

A parent continuously evaluates whether it controls a subsidiary.

Several events may lead to a loss of control of a subsidiary, and not all events are the direct result of actions taken by the parent. The simplest example of the loss of control of a subsidiary is when a parent decides to sell all of its ownership interests in a subsidiary. A loss of control also can result from actions taken by the subsidiary. When a subsidiary issues shares to third parties, the parent's interest is diluted, potentially to the point when the parent no longer controls the subsidiary. A loss of control can also

result if a government, court, administrator or regulator takes legal control of a subsidiary or a group of assets. ASC 810 lists examples that may result in a loss of control of a subsidiary. We believe ASC 810 applies to the loss of control and deconsolidation of any subsidiary or group of assets in the scope of ASC 810-10-40-3A, regardless of how the parent lost control (except for nonreciprocal transfers to owners as specified in ASC 810-10-40-5).

A primary beneficiary may dispose of an interest in a consolidated VIE. A primary beneficiary's disposal of ownership interests may require a reassessment of whether the entity is a VIE and whether the primary beneficiary changed. See section 12 for further guidance. If after reassessing these judgments, the primary beneficiary loses a controlling financial interest, and the transaction is in the scope of ASC 810, the primary beneficiary would use the methodology described in section 19.4.

Similarly, if the subsidiary is a voting interest entity, the parent evaluates whether the subsidiary is still a voting interest entity (see section 12 for guidance on reconsideration events), and if so, whether it no longer has a controlling financial interest.

Pursuant to ASC 810-10-40-4, a parent should deconsolidate a subsidiary or derecognize a group of assets at the date the parent ceases to have a controlling financial interest in that subsidiary or group of assets. Therefore, a parent's financial statements should reflect the consolidation of a subsidiary for each reporting period until it is not required to consolidate the subsidiary. That is, upon the occurrence of a deconsolidation event, it is inappropriate for the parent to assume the event occurred in a prior reporting period to enhance the comparability of financial statements. However, the parent should evaluate whether the deconsolidated entity qualifies for discontinued operations treatment pursuant to ASC 205-20. See our FRD, *Discontinued operations, Accounting Standards Codification 205-20*, for more guidance.

19.2.1

Deconsolidation through multiple arrangements

Excerpt from Accounting Standards Codification

Consolidation – Overall

810-10-40-6

A parent may cease to have a controlling financial interest in a subsidiary through two or more arrangements (transactions). Circumstances sometimes indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all of the terms and conditions of the arrangements and their economic effects. Any of the following may indicate that the parent should account for the multiple arrangements as a single transaction:

- a. They are entered into at the same time or in contemplation of one another.
- b. They form a single transaction designed to achieve an overall commercial effect.
- c. The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- d. One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

Changes in a parent's ownership interests while it maintains control of a subsidiary or group of assets generally are accounted for as equity transactions if the transactions are in the scope of ASC 810. Alternatively, changes in a parent's ownership interests that result in a loss of control that are in the scope of ASC 810 generally give rise to the recognition of a gain or loss. The FASB recognized that because of these accounting differences, transactions might be structured to achieve a specific accounting result.⁹⁶

⁹⁶ See paragraphs B56 and B57 of FAS 160.

Determining whether multiple transactions should be considered as a single transaction depends on facts and circumstances and requires the use of professional judgment. A reporting entity should clearly document its conclusion contemporaneously with the transactions.

19.2.2

Deconsolidation through a bankruptcy proceeding or governmentally imposed restrictions

Excerpt from Accounting Standards Codification

Consolidation – Overall

Scope and Scope Exceptions

810-10-15-10(a)

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.

When an entity within a consolidated group files for bankruptcy, this could affect whether the entity continues to be consolidated. Consolidation considerations include which entities are included in the filing, the status of the bankruptcy proceedings as well as the facts and circumstances of the parent's relationship with the subsidiary (e.g., majority shareholder, priority debt holder or single largest creditor). See section 2.7.2 of our FRD, *Bankruptcies, liquidations and quasi-reorganizations*, for further guidance.

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. However, while a reporting entity should consider the totality of its facts and circumstances, we believe that a lack of exchangeability in and of itself generally would not result in the deconsolidation of a foreign subsidiary. See section 11.3.1 for further details.

19.3

Scope of guidance in ASC 810 on loss of control

Excerpt from Accounting Standards Codification

Consolidation – Overall

Derecognition

810-10-40-3A

The deconsolidation and derecognition guidance in this Section applies to the following:

- a. A subsidiary that is a **nonprofit activity** or a business, except for either of the following:
 1. Subparagraph superseded by Accounting Standards Update No. 2017-05.
 2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360)
 3. A transfer of a good or service in a **contract** with a **customer** within the scope of Topic 606.

- b. A group of assets that is a nonprofit activity or a business, except for either of the following:
 - 1. Subparagraph superseded by Accounting Standards Update No. 2017-05.
 - 2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360)
 - 3. A transfer of a good or service in a contract with a customer within the scope of Topic 606.
- c. A subsidiary that is not a nonprofit activity or a business if the substance of the transaction is not addressed directly by guidance in other Topics that include, but are not limited to, all of the following:
 - 1. Topic 606 on **revenue** from contracts with customers
 - 2. Topic 845 on exchanges of nonmonetary assets
 - 3. Topic 860 on transferring and servicing financial assets
 - 4. Topic 932 on conveyances of mineral rights and related transactions
 - 5. Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

810-10-40-5

If a parent deconsolidates a subsidiary or derecognizes a group of assets through a **nonreciprocal transfer** to **owners**, such as a spinoff, the accounting guidance in Subtopic 845-10 applies...

Implementation Guidance and Illustrations

810-10-55-1A

This Subtopic provides guidance for deconsolidation of a **subsidiary**. If an asset one entity transfers to a second entity in exchange for a **noncontrolling interest** in that second entity is a subsidiary, the gain or loss of a controlling financial interest in that subsidiary is accounted for in accordance with this Subtopic.

A parent deconsolidates a subsidiary or derecognizes a group of assets in a transaction that is in the scope of ASC 810-10-40-3A when that parent no longer has a controlling financial interest in the subsidiary or group of assets.

The deconsolidation and derecognition guidance in ASC 810 applies to interests in:

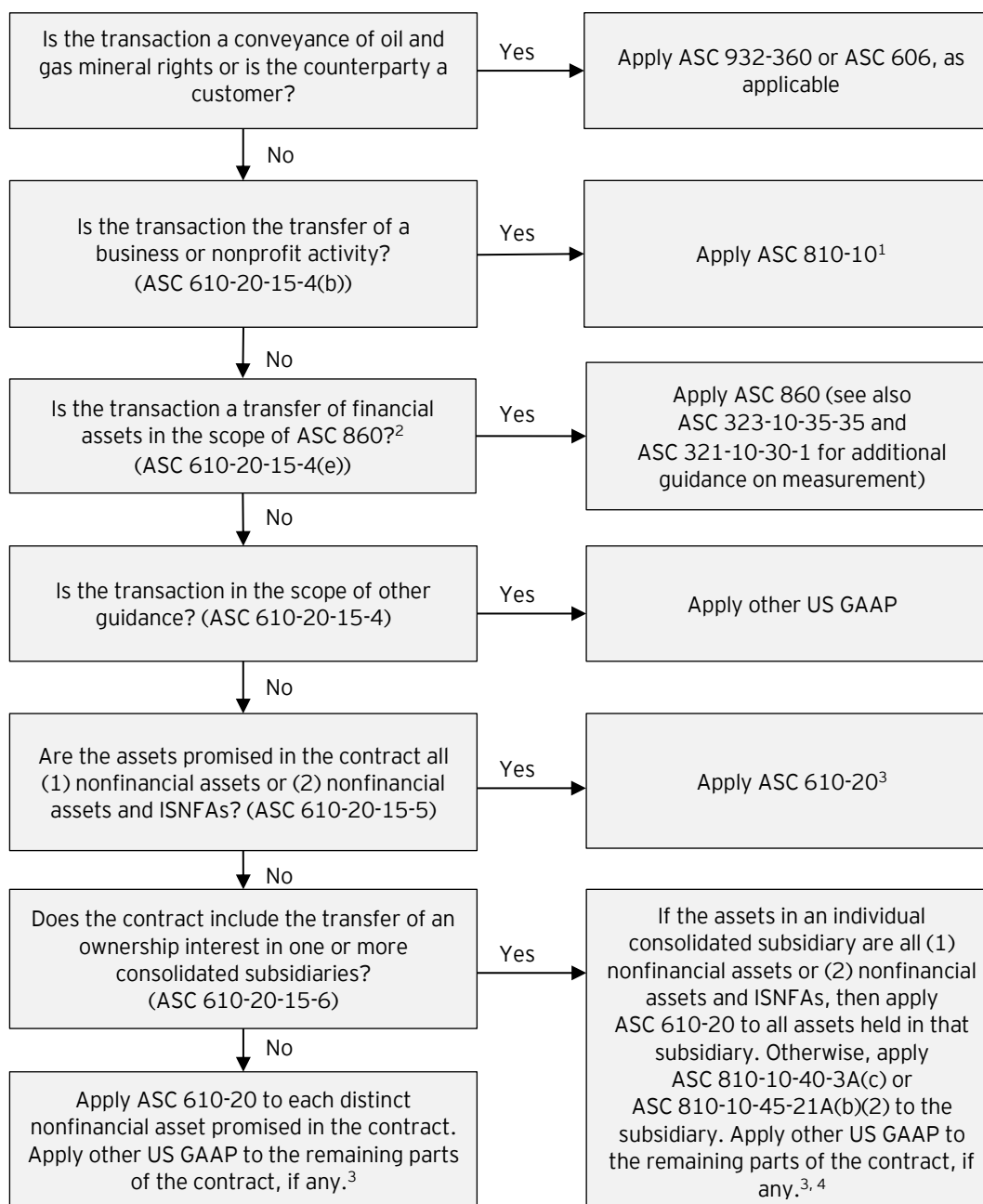
- ▶ A subsidiary that is a business or a nonprofit activity or group of assets that is a business or nonprofit activity, except for a conveyance of oil and gas mineral rights or a revenue transaction from a contract with a customer that is in the scope of ASC 606 (see section 19.3.2.1)
- ▶ A subsidiary that is not a business or a nonprofit activity, but the substance of the transaction is not addressed directly by guidance in other ASC topics (see section 19.3.2.2)

However, if a parent deconsolidates a subsidiary or derecognizes a group of assets that is a business through a nonreciprocal transfer to owners (i.e., in a spinoff) the accounting guidance in ASC 845-10 and in ASC 505-60 applies. See S4, ***Spin-offs and split-offs***, of our Accounting Manual for additional guidance.

ASC 810 lists ASC Topics to consider when determining whether the substance of the transaction is addressed by other US GAAP. However, that list is not exhaustive.

Flowchart of scoping guidance

The following flowchart, which is adapted from a decision tree in ASC 610-20-15-10, helps a reporting entity determine when to apply ASC 810 or other guidance:



¹ Spin-offs and split-offs of businesses are addressed by ASC 505-60.

² Sales of equity method investments, even if those investees only hold nonfinancial assets, such as real estate, are accounted for under ASC 860, unless a scope exception applies.

³ For transactions within the scope of ASC 610-20, see our FRD, *Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)*, for further guidance. ASC 610-20 is applied to each distinct asset promised in the contract. If the contract includes terms or other contractual obligations that are not assets of the seller (e.g., guarantees), these aspects of the contract are separated and accounted for under other US GAAP.

⁴ A reporting entity evaluates all of the assets transferred, collectively, in the contract. If substantially all of the fair value of all of the assets is not concentrated in nonfinancial assets, the reporting entity evaluates each individual consolidated subsidiary (i.e., the reporting entity determines whether substantially all of the fair value of the assets in each subsidiary is concentrated in nonfinancial assets).

The following table summarizes some types of transactions that may fall into each derecognition standard described above:

ASC topic	When applied	Example transactions
ASC 606, <i>Revenue from Contracts with Customers</i>	<ul style="list-style-type: none"> ▶ Sales to customers of nonfinancial assets, regardless of whether they also meet the definition of a business 	<ul style="list-style-type: none"> ▶ Sales of heavy equipment by the equipment manufacturer ▶ Sales of homes by homebuilders
ASC 610-20, <i>Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets</i>	<ul style="list-style-type: none"> ▶ Sales or transfers to noncustomers of (1) nonfinancial assets or (2) nonfinancial assets and ISNFAs that do not meet the definition of a business 	<ul style="list-style-type: none"> ▶ Sales of commercial properties (e.g., office buildings, hotels, manufacturing facilities) by non-real-estate entities ▶ Sales of commercial properties by real estate investment trusts that do not consider selling real estate to be part of their ordinary activities <p><i>Such transactions may also be accomplished through selling the equity of an entity that holds such assets.</i></p>
ASC 810-10, <i>Consolidation – Overall</i>	<ul style="list-style-type: none"> ▶ Sales or transfers of businesses to noncustomers ▶ Sales or transfers of subsidiaries that do not contain solely (1) nonfinancial assets or (2) nonfinancial assets and ISNFAs if no other US GAAP applies 	<ul style="list-style-type: none"> ▶ Sales of a portfolio of hotels that include significant value related to existing receivables, leases to retail tenants and the hotels' brand name (i.e., nonfinancial assets and financial assets that together meet the definition of a business) ▶ Sales of subsidiaries that hold a combination of financial assets (that are not ISNFAs) and nonfinancial assets (e.g., assets consisting of 50% receivables and 50% machinery)⁹⁷
ASC 845, <i>Nonmonetary Transactions</i>	<ul style="list-style-type: none"> ▶ Exchanges of products held for sale in the ordinary course of business (inventory) ▶ Nonreciprocal transactions ▶ Exchanges of financial assets or noncontrolling interests that are outside the scope of ASC 860 	<ul style="list-style-type: none"> ▶ Exchange of finished goods inventory (e.g., car) for finished goods inventory (e.g., a car) ▶ Spin-offs and split-offs (see also ASC 505-60)
ASC 860, <i>Transfers and Servicing</i>	<ul style="list-style-type: none"> ▶ Transfers of financial assets 	<ul style="list-style-type: none"> ▶ Transfers of debt securities, equity securities and equity method investments ▶ Factoring arrangements, transfers of receivables with recourse and securitizations <p><i>Such transactions may also be accomplished through selling the equity of an entity that holds such assets.</i></p>

⁹⁷ If no other guidance directly addresses the substance of the transaction, the entity deconsolidates in accordance with ASC 810.

19.3.1 Loss of control of a business

The derecognition of a business or nonprofit activity upon a loss of control generally is accounted for under ASC 810. However, this guidance does not apply to oil and gas conveyances and revenue transactions with customers (as discussed in sections 19.3.1.1 and 19.3.1.2, respectively).

The definition of a business in ASC 805 requires a reporting entity to first evaluate whether 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. Quantitatively evaluating whether the substantially all threshold is met may be challenging because a reporting entity wouldn't otherwise be required to determine the fair value of all of the assets in a disposition. However, in many transactions, the transferred set of assets will clearly be a business, and the transaction will be in the scope of ASC 810. In other transactions, a reporting entity may need to apply judgment. See section 2.1.3 of our FRD, ***Business combinations***, for further discussion of the definition of a business.

Upon the deconsolidation of a business or a subsidiary in the scope of ASC 810, the parent and subsidiary should evaluate any lease arrangements between the entities under the sale-leaseback guidance in ASC 840 (or sale and leaseback guidance in ASC 842). See sections 8 and 9 of our FRD, ***Lease accounting: Accounting Standards Codification 840, Leases***, or section 7.5 of our FRD, ***Lease accounting: Accounting Standards Codification 842, Leases***, for additional guidance.

19.3.1.1 Scope exception for oil and gas conveyances

Any conveyance of an oil and gas mineral right that is accounted for under ASC 932-360-40 is outside the scope of ASC 810's deconsolidation and derecognition provisions. However, if a company sells all or a portion of a business or a group of assets that include oil and gas mineral rights (or contributes it to another entity), the transaction may be more appropriately accounted for under ASC 810 instead of ASC 932. A reporting entity should consider the guidance and illustrations in ASC 932 to determine whether a transaction represents a conveyance of a mineral property. If the transaction is not addressed directly by the guidance in ASC 932, it should be accounted for under ASC 810 unless other US GAAP applies.

An entity also should consider the intra-entity elimination guidance in section 6.2 of our FRD, ***Equity method investments and joint ventures***, when the recipient is an equity method investee and the transaction is within the scope of ASC 932.

Illustration 19-1: Oil and gas transaction not in the scope of ASC 810

O&G Co. owns a 100% gas mineral interest in a property in Colorado. O&G Co. assigns an operating interest to an unrelated third party, Drilling Co., and retains a non-operating interest in the property. The transaction requires Drilling Co. to drill, develop and operate the property. O&G Co. will participate in the production profits after Drilling Co. recoups its costs.

Analysis

The accounting for this transaction (a pooling of assets in a joint undertaking) is addressed in ASC 932-360-55-3. Therefore, the transaction should be accounted for in accordance with ASC 932 and not ASC 810.

Illustration 19-2: Oil and gas transaction is in the scope of ASC 810

O&G Co. owns 100% of an operating subsidiary, Foreign Sub. Foreign Sub has oil and gas mineral properties and other energy-related operations. O&G Co. sells a 55% interest in those operations to Purchase Co. and concludes that it lost control of Foreign Sub.

Analysis

This type of transaction is not addressed directly in the mineral property conveyance guidance in ASC 932 and, therefore, should be accounted for under the derecognition guidance in ASC 810. We believe ASC 810 is the most appropriate guidance because this transaction represents the sale of a business that happens to include oil and gas mineral properties.

19.3.1.2 Scope exception for revenue contracts with customers (added August 2022)

Regardless of whether the transferred items meet the definition of a business, transactions with customers (i.e., the sale of goods or services that are an output of the entity's ordinary activities) are within the scope of ASC 606.⁹⁸ For the definition of a customer and accounting for transactions within the scope of ASC 606, see our FRD, [Revenue from contracts with customers \(ASC 606\)](#), for more guidance.

19.3.2 Loss of control of a subsidiary that is not a business

If a parent loses control of a subsidiary that is not a business or nonprofit activity, a reporting entity first evaluates the substance of the transaction to identify whether other US GAAP (e.g., transfers of financial assets as discussed in ASC 860, revenue recognition as discussed in ASC 606, sale of nonfinancial assets as discussed in ASC 610-20) applies. If other guidance does not apply, a parent applies ASC 810. This process is illustrated in the flowchart in section 19.3.

ASC 810 lists ASC Topics to consider when determining whether the substance of the transaction is addressed by other US GAAP, which are discussed in the following sections. However, that list is not exhaustive.

19.3.2.1 Loss of control – substance addressed by ASC 606 (updated August 2022)

Transactions with customers (i.e., the sale of goods or services that are an output of the entity's ordinary activities) are within the scope of ASC 606. Therefore, if a reporting entity's ordinary activity is to sell real estate, the reporting entity will account for the loss of control of an entity that holds real estate as a result of a transaction with a customer in accordance with ASC 606. See our FRD, [Revenue from contracts with customers \(ASC 606\)](#), for further guidance and the definition of a customer.⁹⁹

⁹⁸ If an entity sells a nonfinancial asset to a counterparty that is not an output of its ordinary activities and also sells goods or services to the counterparty that are the output of its ordinary activities, we believe the counterparty is considered a customer for the goods or services but not for the sale of the nonfinancial asset. See section 2.2 of our FRD, [Revenue from contracts with customers \(ASC 606\)](#), for further details.

⁹⁹ If an entity sells a nonfinancial asset to a counterparty that is not an output of its ordinary activities and also sells goods or services to the counterparty that are the output of its ordinary activities, we believe the counterparty is considered a customer for the goods or services but not for the sale of the nonfinancial asset. See section 2.2 of our FRD, [Revenue from contracts with customers \(ASC 606\)](#), for further details.

19.3.2.2 **Loss of control – substance addressed by ASC 845 (updated August 2022)**

Exchanges of products held for sale in the ordinary course of business (inventory) are within the scope of ASC 845. Nonreciprocal transactions generally are in the scope of ASC 845. See section N 1.2, *Nonmonetary transactions*, of our Accounting Manual for additional guidance.

19.3.2.3 **Loss of control – substance addressed by ASC 860**

The loss of control of a subsidiary that holds only financial assets may be a transaction that is in substance within the scope of ASC 860, and not within ASC 810. However, a reporting entity should carefully consider the scope of ASC 860 before applying that guidance.¹⁰⁰

A sale of a financial asset (e.g., an equity method investment) is generally in the scope of ASC 860, unless the financial asset is determined to be an ISNFA as discussed in section 2.4.1 of the FRD, *Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)*. That is, a financial asset, including an equity method investment, is in the scope of ASC 610-20 if it is transferred in a contract as part of a group of assets and substantially all of the fair value of the group of assets is concentrated in nonfinancial assets (and no other scope exceptions from ASC 610-20 apply). See section 1.2 of our FRD, *Transfers and servicing of financial assets*, for more guidance on the scope of ASC 860.

Under ASC 610-20, reporting entities do not “look through” to the underlying assets and liabilities in an unconsolidated entity in which they hold an equity investment to determine which derecognition guidance to apply. Instead, reporting entities evaluate the form of the asset that is transferred (e.g., an equity method investment) to determine the appropriate derecognition guidance. Therefore, a reporting entity accounts for a transfer of a controlling interest in an entity that holds an investment in an unconsolidated entity that is not an ISNFA as a transfer of the investment (a financial asset), not a transfer of the underlying assets and liabilities held by the unconsolidated investee (which might include nonfinancial assets).

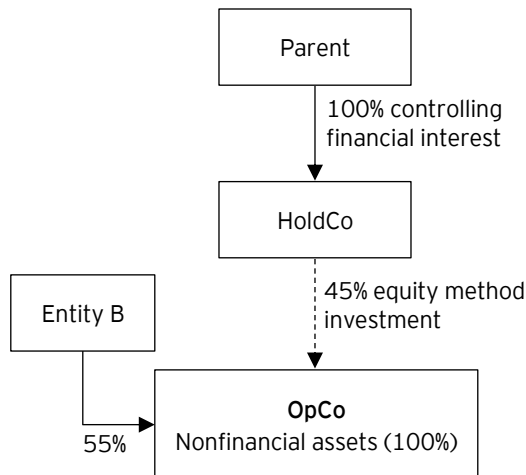
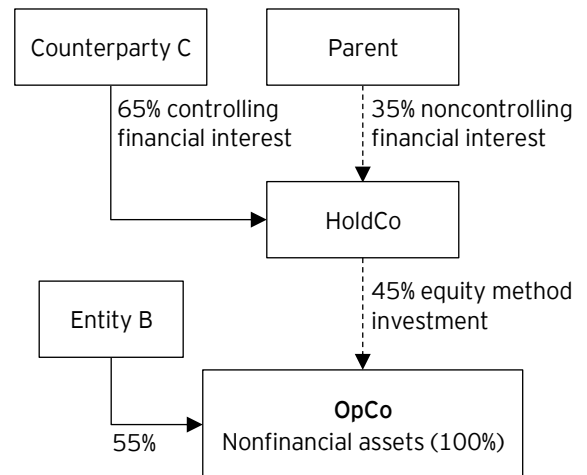
However, one of the first considerations for a transfer of financial assets to be accounted for as a sale under ASC 860 in the consolidated financial statements of the transferor is whether the transferee would be consolidated by the transferor. That is because a sale to a consolidated affiliate would not result in a transfer of the risks and rewards of ownership to new owners. Therefore, even if the transaction is within the scope of ASC 860, if the parent retains control of the subsidiary that holds financial assets, there may be no gain or loss on the transaction, and it likely will be accounted for as a failed sale. See section 1.4 and section 8 of our FRD, *Transfers and servicing of financial assets*, for more guidance.

The following example illustrates a sale in the scope of ASC 860. This transaction would not be in the scope of ASC 810, even though it is the sale of a subsidiary, because the substance of the transaction is addressed by ASC 860.

¹⁰⁰ In determining whether the exchange is accounted for under ASC 860, entities should consider whether the exchange meets the definition of a “transfer” or is specifically exempted from its scope (e.g., the exchange involves investments by owners or distributions to owners of a business entity (ASC 860-10-15-4(f))).

Illustration 19-3: Sale of a consolidated entity that holds an equity method investment

Parent owns a 100% controlling interest in HoldCo. HoldCo's only asset is an equity method investment in OpCo. OpCo holds only nonfinancial assets. Parent sells a 65% controlling interest in HoldCo to Counterparty C. The transaction is not with a customer, so it is not in the scope of ASC 606. In addition, HoldCo does not meet the definition of a business.

Before:**After:****Analysis**

Parent evaluates the transfer and concludes that, in substance, it is transferring a financial asset in the scope of ASC 860. The transaction is not in the scope of ASC 610-20, even though all of the fair value of OpCo's assets is concentrated in nonfinancial assets. This is because Parent does not look through to evaluate the underlying assets of OpCo since HoldCo only has a noncontrolling interest (equity method investment) in OpCo. Instead, Parent evaluates the form of the asset that is transferred (e.g., a controlling interest in HoldCo, which only holds an equity method investment in OpCo) to determine the appropriate derecognition guidance.

This conclusion would not change even if the assets held by OpCo met the definition of a business because HoldCo doesn't control OpCo (i.e., it only has an equity method investment in OpCo). The transaction is not in the scope of ASC 810 because the substance of the transaction is addressed by other guidance (in this case, ASC 860). However, the Parent must evaluate whether it lost a controlling financial interest in HoldCo under ASC 810 as one of the steps to determining whether a sale occurred under ASC 860. Refer to section 1.4 of our FRD, *Transfers and servicing of financial assets*, for guidance.

Note: If HoldCo controlled OpCo, Parent would look through HoldCo and consider the nature of the assets held by OpCo to determine which guidance applies to the transaction (e.g., ASC 606, ASC 810 or ASC 610-20).

19.3.2.4 Loss of control – substance addressed by ASC 932 (added August 2022)

Any conveyance of an oil and gas mineral right that is accounted for under ASC 932-360-40 is outside the scope of ASC 810's deconsolidation and derecognition provisions. However, if a company sells all or a portion of a subsidiary or a group of assets that include oil and gas mineral rights (or contributes it to another entity), the transaction may be more appropriately accounted for under ASC 810 instead of ASC 932. A reporting entity should consider the guidance and illustrations in ASC 932 to determine whether a transaction represents a conveyance of a mineral property. If a transaction is not addressed directly by the guidance in ASC 932, it should be accounted for under ASC 810 unless other US GAAP applies. Refer to the illustrations in section 18.3.2.1.1 for examples of assessing the scope of changes in ownership of oil and gas transactions.

An entity also should consider the intra-entity elimination guidance in section 6.2 of our FRD, *Equity method investments and joint ventures*, when the recipient is an equity method investee and the transaction is within the scope of ASC 932.

19.3.2.5 Loss of control – substance addressed by ASC 610-20 (added August 2022)

Excerpt from Accounting Standards Codification

Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets

Scope and Scope Exceptions

In Substance Nonfinancial Assets

610-20-15-6

When a contract includes the transfer of ownership interests in one or more consolidated subsidiaries that is not a business, and substantially all of the fair value of the assets promised to a counterparty in the contract is not concentrated in nonfinancial assets, an entity shall evaluate whether substantially all of the fair value of the assets promised to the counterparty in an individual subsidiary within the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets in an individual subsidiary is concentrated in nonfinancial assets, then the financial assets in that subsidiary are in substance nonfinancial assets. (See Case C of Example 1 in paragraphs 610-20-55-9 through 55-10.)

610-20-15-8

If all of the assets promised to a counterparty in an individual consolidated subsidiary within a contract are not nonfinancial assets and/or in substance nonfinancial assets, an entity shall apply the guidance in paragraph 810-10-40-3A(c) or 810-10-45-21A(b)(2) to determine the guidance applicable to that subsidiary.

A reporting entity should consider whether the substance of a transaction in which it loses control of a subsidiary that is not a business is addressed by ASC 610-20, which applies to the recognition of gains and losses on transfers of nonfinancial assets and ISNFAs that do not meet the definition of a business to counterparties that are not customers.¹⁰¹ ISNFA is a defined term in ASC 610-20. An ISNFA is “a financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets.”¹⁰²

¹⁰¹ Here and below, references to a business also include a nonprofit activity.

¹⁰² ASC 610-20-15-5.

If the transaction involves the sale of an ownership interest in one or more subsidiaries that is not a business, a reporting entity first evaluates whether substantially all of the fair value of the assets in the contract, collectively, is concentrated in nonfinancial assets. To make this assessment, a reporting entity looks through any subsidiaries to the underlying assets of the subsidiaries. If substantially all of the fair value of the assets, *collectively*, in the contract is concentrated in nonfinancial assets, the financial assets are ISNFAs, and all the assets in the contract (including the assets in the subsidiaries) are in the scope of ASC 610-20.

If the transaction involves the sale or transfer of an ownership interest in one or more consolidated subsidiaries, and substantially all of the fair value of the assets promised to a counterparty in the contract is *not* concentrated in nonfinancial assets, each subsidiary must be evaluated individually to determine whether substantially all of the fair value of the promised assets held in each subsidiary is concentrated in nonfinancial assets. If substantially all of the fair value of the assets in an individual subsidiary is concentrated in nonfinancial assets, the financial assets in that subsidiary are in substance nonfinancial assets and are in the scope of ASC 610-20. The process above is illustrated in the flowchart in section 19.3. If the substance of the transaction is within the scope of ASC 610-20, it is outside the scope of the deconsolidation and derecognition guidance in ASC 810. However, the reporting entity must still address whether it has lost control of the subsidiary under ASC 810 because ASC 610-20 follows a two-step derecognition model to determine whether (and when) to derecognize the asset as follows:

- ▶ Step 1: Apply the guidance in ASC 810 to determine whether the reporting entity has a controlling financial interest in the legal entity that holds the asset after the transaction
- ▶ Step 2: Apply certain guidance in ASC 606 to determine whether (and when) control transfers and how to measure the associated gain or loss

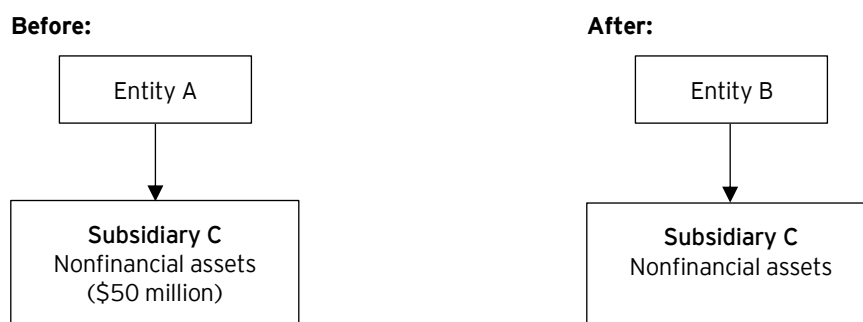
See sections 2 and 3 our FRD, ***Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)***, for more guidance on the definition of an ISNFA and the two-step derecognition model and see our FRD, ***Revenue from contracts with customers (ASC 606)***, for more guidance on the principles of ASC 606.

The following examples illustrate the transfer of nonfinancial assets and financial assets that are not a business in a single subsidiary.

Illustration 19-4: Transfer of ownership interest in a consolidated subsidiary

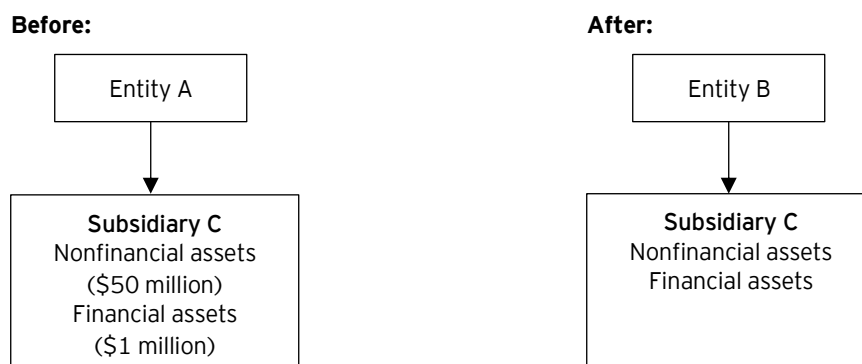
Example 1

Entity A sells its 100% ownership interest in Subsidiary C to Entity B and loses a controlling financial interest (as defined in ASC 810) in Subsidiary C. Subsidiary C holds nonfinancial assets¹ with a fair value of \$50 million. Subsidiary C is not a business, and Entity B is not Entity A's customer in this transaction.



Example 2

Entity A sells its 100% ownership interest in Subsidiary C to Entity B and loses a controlling financial interest (as defined in ASC 810) in Subsidiary C. Subsidiary C holds nonfinancial assets¹ with a fair value of \$50 million and financial assets with a fair value of \$1 million. Subsidiary C is not a business, and Entity B is not Entity A's customer in this transaction.

**Analysis**

In Example 1, Entity A concludes that the sale of Subsidiary C is in the scope of ASC 610-20 because all assets held by Subsidiary C are nonfinancial assets.

In Example 2, Entity A determines that substantially all of the fair value of the assets (i.e., 98%)² is concentrated in nonfinancial assets (i.e., the financial assets are ISNFAs). Therefore, the sale of Subsidiary C is in the scope of ASC 610-20.

Note: In Examples 1 and 2, Entity A evaluates the underlying assets held by Subsidiary C because the subsidiary was consolidated by Entity A before the transaction with Entity B.

In addition, the ASC 610-20 scoping assessment would be the same if Entity A also transferred cash or cash equivalents to Entity B and/or Entity B assumed or relieved any liabilities (see ASC 610-20-15-7).

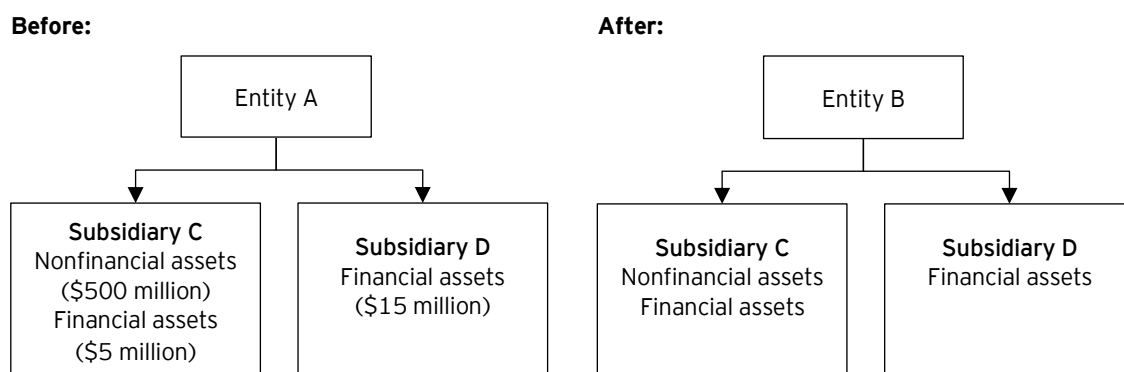
¹ These nonfinancial assets are not subject to a scope exception in ASC 610-20.

² Calculated as \$50 million of nonfinancial assets divided by \$51 million of total assets.

The following example illustrates the transfer of nonfinancial assets and financial assets that are not a business in multiple subsidiaries and substantially all of the fair value of the underlying assets in the contract is concentrated in nonfinancial assets.

Illustration 19-5: Transfer of ownership interests in two consolidated subsidiaries – substantially all of the fair value of the underlying assets in the contract is concentrated in nonfinancial assets

Entity A sells its 100% ownership interests in Subsidiary C and Subsidiary D to Entity B and loses a controlling financial interest (as defined in ASC 810) in Subsidiary C and D. Subsidiary C holds nonfinancial assets¹ with a fair value of \$500 million and financial assets with a fair value of \$5 million. Subsidiary D holds financial assets with a fair value of \$15 million. Subsidiary C and Subsidiary D together are not a business, and Entity B is not Entity A's customer in this transaction.



Analysis

Entity A first evaluates all of the underlying assets in the contract.² Entity A determines that substantially all of the fair value of the underlying assets (i.e., 96%)³ is concentrated in nonfinancial assets. Therefore, the financial assets in Subsidiary C and Subsidiary D are ISNFAs. The sale of Entity A's ownership interests in Subsidiary C and Subsidiary D is in the scope of ASC 610-20. Note that the assessment is first made at the contract level. That is, it is irrelevant that all of the assets in Subsidiary D are financial assets because Entity A determines that the entire contract is in the scope of ASC 610-20.

Note: This assessment would be the same if Entity A also transferred cash or cash equivalents to Entity B and/or Entity B assumed or relieved any liabilities (see ASC 610-20-15-7).

¹ These nonfinancial assets are not subject to a scope exception in ASC 610-20.

² Following the guidance in ASC 610-20-15-5, the reporting entity evaluates the underlying assets held by its consolidated subsidiaries.

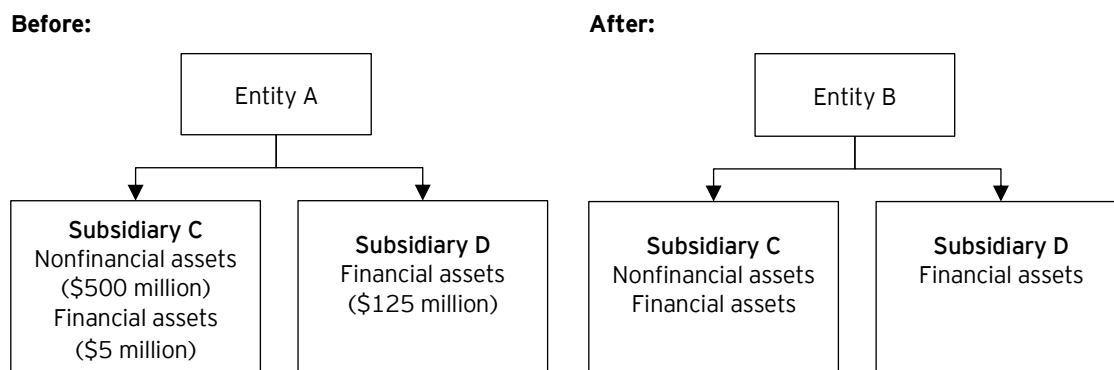
³ Calculated as \$500 million of nonfinancial assets divided by \$520 million of total assets.

The following example illustrates the transfer of nonfinancial assets and financial assets that are not a business in multiple subsidiaries, and substantially all of the fair value of the underlying assets in the contract is *not* concentrated in nonfinancial assets. Each subsidiary is evaluated individually.

Illustration 19-6: Transfer of ownership interests in two consolidated subsidiaries

Entity A sells its 100% ownership interests in Subsidiary C and Subsidiary D to Entity B and loses a controlling financial interest (as defined in ASC 810) in Subsidiary C and Subsidiary D. Subsidiary C and Subsidiary D together are not a business, and Entity B is not Entity A's customer in this transaction.

Subsidiary C holds nonfinancial assets¹ with a fair value of \$500 million and financial assets with a fair value of \$5 million. Subsidiary D holds financial assets with a fair value of \$125 million.



Analysis

Entity A first evaluates all of the underlying assets in the contract.² Entity A determines that substantially all of the fair value of the assets in the contract is not concentrated in nonfinancial assets (approximately 79%³ of the fair value of the assets is concentrated in nonfinancial assets). Therefore, Entity A evaluates each individual consolidated subsidiary separately.

Entity A determines that substantially all of the fair value of the assets in Subsidiary C (i.e., 99%)⁴ is concentrated in nonfinancial assets. Therefore, the financial assets in Subsidiary C are ISNFAs, and the sale of Entity A's ownership interest in Subsidiary C is in the scope of ASC 610-20.

Subsidiary D holds only financial assets (i.e., the financial assets are *not* ISNFAs because substantially all of the fair value of the assets in Subsidiary D is not concentrated in nonfinancial assets). As a result, the sale of Entity A's ownership interest in Subsidiary D (and the assets held by Subsidiary D) is evaluated first under ASC 810. Entity A determines whether other guidance addresses the substance of the transaction before deconsolidating a subsidiary that is not a business under ASC 810. In this fact pattern, the sale of Subsidiary D is accounted for under ASC 860 because the substance of the transaction is the sale of financial assets, since Subsidiary D only holds financial assets (assuming no scope exceptions in ASC 860 are met).

Note: This assessment would be the same if Entity A also transferred cash or cash equivalents to Entity B and/or Entity B assumed or relieved any liabilities (see ASC 610-20-15-7).

¹ These nonfinancial assets are not subject to a scope exception in ASC 610-20.

² Following the guidance in ASC 610-20-15-5, the reporting entity evaluates the underlying assets held by its consolidated subsidiaries.

³ Calculated as \$500 million of nonfinancial assets divided by \$630 million of total assets.

⁴ Calculated as \$500 million of nonfinancial assets divided by \$505 million of total assets.

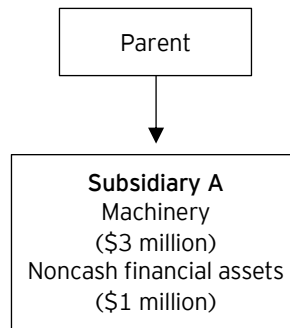
19.3.2.6

Loss of control of a subsidiary that is not a business – substance not addressed by other GAAP

When a parent loses control of a subsidiary that is not a business or nonprofit activity and the substance of the transaction is not addressed by other GAAP, the parent accounts for the transaction in accordance with ASC 810.

The following examples illustrates the transfer of nonfinancial assets and financial assets that are not a business, and substantially all of the fair value of the underlying assets in the contract is not concentrated in nonfinancial assets.

Illustration 19-7: Transfer of ownership interests in a consolidated subsidiary – substantially all of the fair value of the underlying assets in the contract is not concentrated in nonfinancial assets

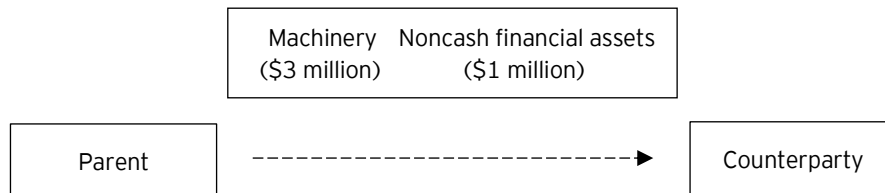


Parent enters into a contract to sell Sub A. The counterparty is not a customer as defined in ASC 606, and the assets sold do not meet the definition of a business under ASC 805. Sub A holds machinery and noncash financial assets with fair values of \$3 million and \$1 million, respectively.

Substantially all of the fair value of the assets promised in the contract and in Sub A is *not* concentrated in nonfinancial assets. Therefore, the financial assets in the contract are not ISNFAs, and the transaction is not in the scope of ASC 610-20.

Therefore, the sale of Sub A would be in the scope of ASC 810 unless other guidance addresses the substance of the transaction. That is, Parent would *not* separate the nonfinancial assets from the financial assets but would instead account for the derecognition of the subsidiary as one unit of account in the scope of ASC 810.

Illustration 19-8: Transferring nonfinancial assets and financial assets outside an entity



Parent enters into a contract to sell machinery and noncash financial assets with fair values of \$3 million and \$1 million, respectively. The counterparty is not a customer as defined in ASC 606, and the assets transferred do not meet the definition of a business under ASC 805. Since there is no loss of control of a business or a subsidiary, the transaction would be outside the scope of ASC 810.

19.3.3 Loss of control through a transfer under common control

See section C.5 of our FRD, *Business combinations*, for a discussion of the accounting and reporting by the transferring entity for the transfer of certain subsidiaries or certain groups of assets between entities under common control.

19.4 Calculate the gain or loss upon losing control

Excerpt from Accounting Standards Codification

Consolidation – Overall

Derecognition

810-10-40-5

If a parent deconsolidates a subsidiary or derecognizes a group of assets through a **nonreciprocal transfer to owners**, such as a spinoff, the accounting guidance in Subtopic 845-10 applies. Otherwise, a parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:

- a. The aggregate of all of the following:
 1. The fair value of any consideration received
 2. The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized
 3. The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated.
- b. The carrying amount of the former subsidiary's assets and liabilities or the carrying amount of the group of assets.

When a subsidiary or group of assets is deconsolidated or derecognized in a transaction in the scope of ASC 810-10-40-3A, the carrying amounts of the previously consolidated subsidiary's assets and liabilities or group of assets are removed from the consolidated statement of financial position.

Generally, a gain or loss is recognized as the difference between the following two amounts:

- ▶ The sum of:
 - ▶ The fair value of any consideration received (see section 19.4.2)
 - ▶ The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized (see section 19.4.3)
 - ▶ The carrying amount of any noncontrolling interest in the former subsidiary (including any AOCI attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated (see section 19.4.4)
- ▶ The carrying amount of the former subsidiary's assets and liabilities or the carrying amount of the group of assets (see section 19.4.5)

The loss of control is deemed to be a significant economic event.¹⁰³ Therefore, when a reporting entity loses control of a subsidiary or a group of assets in the scope of ASC 810-10-40-3A, but retains a noncontrolling interest in the former subsidiary or the entity that acquired the group of assets, the retained interest is measured at fair value and is included in the calculation of the gain or loss upon deconsolidation of the subsidiary or derecognition of a group of assets.

Illustration 19-9: Calculating a gain or loss upon a loss of control

Company A has a 90% controlling financial interest in Company B, a business. On 31 December 20X6, the carrying amount of Company B's net assets is \$100 million, and the carrying amount attributable to the nonredeemable noncontrolling interest in Company B (including the noncontrolling interest's share of AOCI) is \$10 million.

On 1 January 20X7, Company A sells 70% of Company B to a third party for cash proceeds of \$108 million and the transaction is in the scope of ASC 810-10-40-3A. As a result of the sale, Company A loses control of Company B but retains a 20% noncontrolling interest in Company B.

The fair value of the retained interest on that date is \$24 million (this number is assumed and cannot be determined based on the acquisition of the 70% interest because that price may include a control premium). The gain on sale of the 70% interest in Company B is calculated as follows (in millions):

Cash proceeds	\$ 108
Fair value of retained interest	24
Carrying amount of the nonredeemable noncontrolling interest	<u>10</u>
	142
Less:	
Carrying amount of Company B's net assets	<u>100</u>
Gain	<u>\$ 42</u>

Company A's journal entry to record the deconsolidation of Company B is as follows:

Cash	\$ 108	
Investment in Company B	24	
Noncontrolling interest	10	
Net assets of Company B		\$ 100
Gain on sale		42

Company A subsequently may account for its retained interest as a financial asset or as an equity method investment in accordance with ASC 323. See our FRD, [***Equity method investments and joint ventures***](#), for further guidance.

See section 19.4.4 for guidance if the noncontrolling interest were redeemable.

¹⁰³ See paragraph B54 of FAS 160.

19.4.1 Identify other elements of the transaction

Excerpt from Accounting Standards Codification

Consolidation – Overall

SEC Materials

810-10-S99-5 (SAB Topic 5E, Accounting for Divestiture of a Subsidiary or Other Business Operations)

The following is the text of SAB Topic 5.E, Accounting for Divestiture of a Subsidiary or Other Business Operations.

Facts: Company X transferred certain operations (including several subsidiaries) to a group of former employees who had been responsible for managing those operations. Assets and liabilities with a net book value of approximately \$8 million were transferred to a newly formed entity—Company Y—wholly owned by the former employees. The consideration received consisted of \$1,000 in cash and interest bearing promissory notes for \$10 million, payable in equal annual installments of \$1 million each, plus interest, beginning two years from the date of the transaction. The former employees possessed insufficient assets to pay the notes and Company X expected the funds for payments to come exclusively from future operations of the transferred business.

Company X remained contingently liable for performance on existing contracts transferred and agreed to guarantee, at its discretion, performance on future contracts entered into by the newly formed entity. Company X also acted as guarantor under a line of credit established by Company Y.

The nature of Company Y's business was such that Company X's guarantees were considered a necessary predicate to obtaining future contracts until such time as Company Y achieved profitable operations and substantial financial independence from Company X.

Question: If deconsolidation of the subsidiaries and business operations is appropriate, can Company X recognize a gain?

Interpretive Response: Before recognizing any gain, Company X should identify all of the elements of the divestiture arrangement and allocate the consideration exchanged to each of those elements. In this regard, we believe that Company X would recognize the guarantees at fair value in accordance with FASB ASC Topic 460, Guarantees; the contingent liability for performance on existing contracts in accordance with FASB ASC Topic 450, Contingencies; and the promissory notes in accordance with FASB ASC Topic 310, Receivables, and FASB ASC Topic 835, Interest.

When a parent loses control of a subsidiary, the parent should identify all of the elements of the divestiture arrangement and allocate the consideration exchanged to each of those elements. For example, if the divestiture arrangement included elements of guarantees and promissory notes, the parent would recognize the guarantees at fair value in accordance with ASC 460 and recognize the promissory notes in accordance with ASC 835 and ASC 310.

We believe the parent also should identify any off-market executory contracts that should be recognized as intangible assets, as discussed in section 19.4.2.

19.4.2 Measure the fair value of consideration received

To calculate a gain or loss upon the deconsolidation of a subsidiary or derecognition of a group of assets in the scope of ASC 810-10-40-3A, a reporting entity must first determine the fair value of any consideration received and the fair value of any retained noncontrolling investment in the former subsidiary or groups of assets. When the consideration received is cash or when the retained noncontrolling investment in the former subsidiary or group of assets is a publicly traded equity interest, this determination may be relatively straightforward. However, in other circumstances, the determination may be more challenging.

The facts and circumstances of a deconsolidation event should be evaluated carefully before recording a gain or loss. Consistent with the disclosure provisions included within ASC 810-10-50-1B and described further in section 23, we believe it is appropriate to disclose the details of the computation of any material gain or loss.

ASC 810-10-40-5 states that any consideration received should be measured at fair value but does not specify what constitutes consideration received. Consideration received may take many forms, including cash, tangible and intangible assets, financial instruments or contingent consideration. We believe it generally is appropriate to measure consideration received at its fair value regardless of its form (see section 19.4.2.1 below for further guidance on contingent consideration). In evaluating the nature and amount of consideration received, it may be helpful to consider ASC 805 regarding consideration transferred. See section 6 of our FRD, *Business combinations*, for further guidance.

We believe the determination of the fair value of any consideration received should contemplate any off-market executory contracts. For example, if upon deconsolidation, a favorable supply contract (from the reporting entity's perspective) exists between the reporting entity and its former subsidiary, we believe that an intangible asset should be recorded by the reporting entity for the off-market component of the supply contract. The effect of this accounting is to increase the gain (or reduce the loss) recorded upon deconsolidation because presumably the consideration received was reduced by the favorable supply contract.

19.4.2.1

Accounting for contingent consideration upon a loss of control (updated June 2023)

In certain instances, a transfer of a controlling financial interest in a subsidiary involves contingent consideration. For example, when a reporting entity sells a controlling financial interest in a subsidiary, the acquirer may promise to deliver cash, additional equity interests or other assets to the seller after the sale date if certain specified events occur or conditions are met in the future. These contingencies frequently are based on future earnings or changes in the market price of the subsidiary's stock over specified periods after the date of the sale. However, they might be based on other factors (e.g., components of earnings, product development milestones, cash flow levels, the successful completion of third-party contract negotiations).

The basis for recognition and measurement of contingent consideration in deconsolidation is not addressed in ASC 810. Therefore, a reporting entity that deconsolidates a subsidiary or derecognizes a group of assets in the scope of ASC 810-10-40-3A must look to other guidance to account for contingent consideration. If contingent consideration meets the definition of a derivative, it should be accounted for under ASC 815. If contingent consideration does not meet the definition of a derivative, there is diversity in practice in how sellers account for contingent consideration. Some sellers recognize it initially at fair value while others recognize it when the contingency is resolved. Still others may apply a different approach.

We believe the basis for recognition and measurement of contingent consideration receivable by the seller is an accounting policy that should be applied on a consistent basis. The EITF considered this matter as part of EITF 09-4 but did not reach a consensus. Companies should carefully consider the accounting for these transactions. Discussed below are two approaches that are applied in practice.

Alternative 1: fair value approach

ASC 810-10-40-5 requires that the measurement of any gain or loss on deconsolidation of a subsidiary or derecognition of a group of assets in the scope of ASC 810 include the fair value of "any consideration received." We believe that this could be interpreted to include contingent consideration. Thus, we believe the seller may initially recognize an asset from the buyer equal to the fair value of any contingent consideration received upon deconsolidation. This view is consistent with the requirement in ASC 805 that an acquirer recognize contingent consideration obligations as of the acquisition date as part of consideration transferred in exchange for an acquired business.

If a seller follows an accounting policy to initially recognize an asset equal to the fair value of the contingent consideration, we believe it also must elect an accounting policy to subsequently measure the contingent consideration under either of the following approaches:

- ▶ Remeasure at fair value by electing the fair value option provided in ASC 825-10-25 (assuming the gain contingency is a financial instrument eligible for the fair value option)
- ▶ Recognize increases in the carrying amount of the asset using the gain contingency guidance in ASC 450-30 and recognize impairments based on the guidance in ASC 450-20-25-2

Alternative 2: loss recovery approach

We believe it also is reasonable to conclude that contingent consideration is not required to be measured at fair value. In that circumstance, we believe it is acceptable to apply a loss recovery approach by analogizing to the accounting for insurance recoveries on property and casualty losses.

Property and casualty losses are accounted for in accordance with ASC 610-30. Under that guidance, when a nonmonetary asset (e.g., property, equipment) is involuntarily converted to a monetary asset (e.g., receipt of insurance proceeds upon the occurrence of an insured event), the loss on the derecognition of the nonmonetary asset must be recognized even when a reporting entity reinvests or is obligated to reinvest the monetary assets in a replacement asset.

Anticipated insurance proceeds up to the amount of the loss recognized are called insurance recoveries and may be recognized when it is probable¹⁰⁴ that they will be received. Therefore, some or all of the anticipated insurance recoveries may be recognized. Specifically, anticipated insurance recoveries may be recognized at the lesser of the amount of (1) the proceeds for which the likelihood of receipt is probable or (2) the total loss recognized. Insurance proceeds in excess of the amount of the loss recognized are subject to the gain contingency guidance in ASC 450-30 and are not recognized until all contingencies related to the insurance claim are resolved.

When analogizing the initial recognition of contingent consideration in deconsolidation to the accounting for insurance recoveries on property and casualty losses, a reporting entity would compare the fair value of the consideration received, excluding the contingent consideration, to the carrying amount of the net assets that are deconsolidated under ASC 810. If the fair value of the consideration received, excluding the contingent consideration, is less than the carrying amount of the deconsolidated assets, the initial measurement of the contingent consideration asset would be limited to the difference between those amounts. That is, if it is probable that contingent consideration will be received, an asset would be recognized and measured initially at the lesser of (1) the amount of probable future proceeds or (2) the difference between the fair value of the consideration received, excluding the contingent consideration, and the carrying amount of the deconsolidated net assets. Subsequent recognition and measurement would be based on the gain contingency guidance in ASC 450-30-25-1 (i.e., a contingency that might result in a gain usually should not be reflected in the financial statements because doing so might recognize revenue before it is realized). Any subsequent impairments would be recognized based on ASC 450-20-25-2.

If the fair value of the consideration received, excluding the contingent consideration, is greater than the carrying amount of the deconsolidated net assets, no contingent consideration asset would be recognized initially. Subsequent recognition and measurement of the contingent consideration would be based on the gain contingency model under ASC 450-30 and any subsequent impairment would be recognized based on ASC 450-20-25-2.

¹⁰⁴ The ASC master glossary defines probable as: “the future event or events are likely to occur.”

The following flowchart shows how an entity evaluates the alternatives that may be applied to contingent consideration in a deconsolidation transaction:

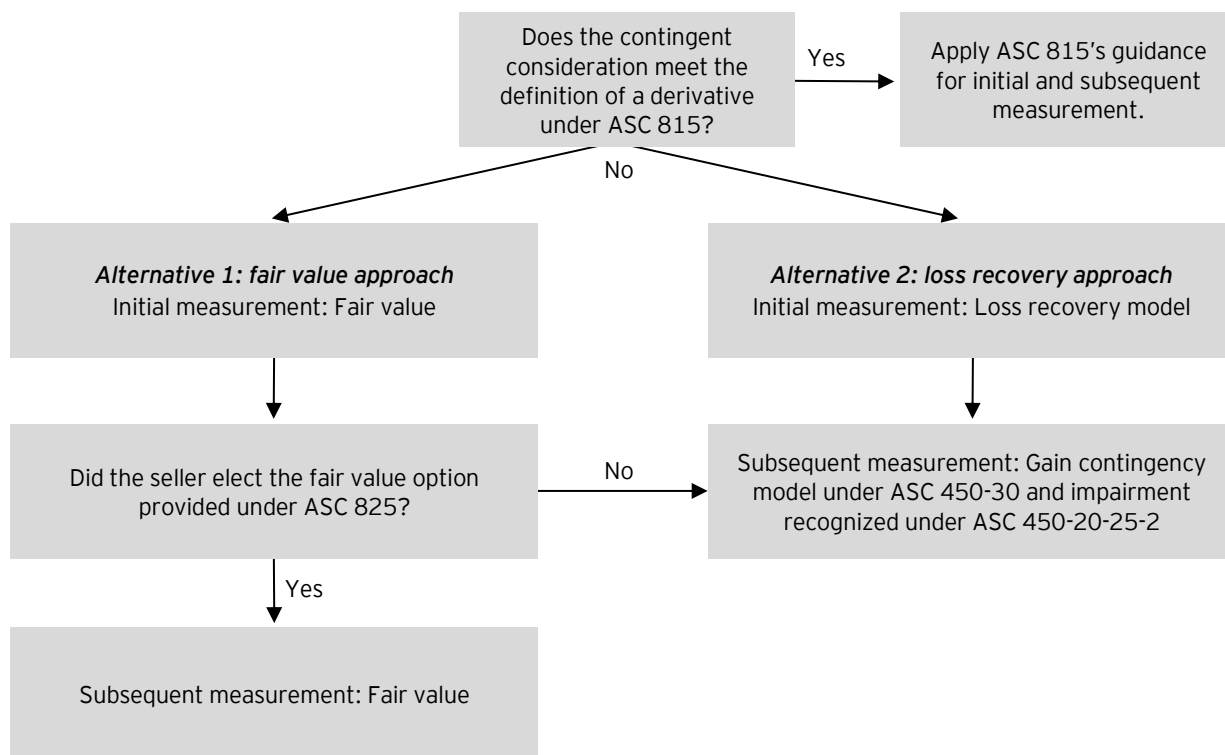


Illustration 19-10 demonstrates these two alternatives.

Illustration 19-10: Accounting for contingent consideration in deconsolidation

Company A has a 100% controlling financial interest in Company B, a business in the scope of ASC 810-10-40-3A. On 31 December 20X6, the carrying amount of Company B's net assets is \$150 million. On 1 January 20X7, Company A sells 100% of Company B to a third party for cash proceeds of \$75 million and a promise by the third party to deliver additional cash annually over the next five years based on a percentage of Company B's annual earnings above an agreed upon target. The fair value of the contingent consideration is determined to be \$175 million on 1 January 20X7. Company A determines it is probable that it will receive \$225 million¹⁰⁵ in total contingent consideration over the life of the arrangement.

Fair value approach

The gain on sale of the 100% interest in Company B is calculated as follows (in millions):

Cash proceeds	\$ 75
Fair value of the contingent consideration	<u>175</u>
	250
Less:	
Carrying amount of Company B's net assets	<u>150</u>
Gain	<u>\$ 100</u>

¹⁰⁵ This amount reflects the total cash that is probable of receipt under the terms of the arrangement as determined using a reasonable estimate of the earnings of Company B over the next five years. No discount factor or other fair value adjustments are applied in determining this amount.

The journal entry to record Company B's deconsolidation follows:

Cash	\$ 75	
Contingent consideration receivable	175	
Net assets of Company B		\$ 150
Gain on sale		100

If Company A applies the fair value accounting policy, we believe Company A also must elect an accounting policy to subsequently measure the contingent consideration under either of the following approaches:

- ▶ Remeasure at fair value by electing the fair value option provided in ASC 825-10-25
- ▶ Recognize increases in the carrying amount of the asset using the gain contingency guidance in ASC 450-30 and recognizing impairments based on the guidance in ASC 450-20-25-2

Loss recovery approach

Company A would compare the fair value of the consideration received, excluding the contingent consideration, to the carrying amount of the assets that are deconsolidated under ASC 810.

Cash proceeds	\$ 75
Less:	
Carrying amount of Company B's net assets	<u>150</u>
Difference	<u>\$ (75)</u>

Because the fair value of the consideration received, excluding the contingent consideration, is less than the carrying amount of the deconsolidated assets, an asset would be recognized and measured initially at the lesser of the amount of probable future proceeds or the difference between those amounts.

In this example, the difference of \$75 million calculated above is less than the probable future proceeds of \$225 million. Therefore, a contingent consideration asset would be recognized and measured initially at \$75 million. No gain would be recognized when initially recording this transaction.

The journal entry to record Company B's deconsolidation would be as follows:

Cash	\$ 75	
Contingent consideration receivable	75	
Net assets of Company B		\$ 150

If Company A elects to apply this alternative, subsequent increases in the carrying amount of the asset would be recognized using the gain contingency guidance in ASC 450-30-25-1 and any subsequent impairments would be recognized based on ASC 450-20-25-2.

19.4.3

Measure the fair value of any retained noncontrolling investment

A retained noncontrolling investment may take many forms, including common stock investments, preferred stock investments or debt interests (see section 19.4.3.1). We believe it generally is appropriate to measure any noncontrolling investment at its fair value, regardless of its form.

When determining the fair value of any retained noncontrolling investment in the former subsidiary, consideration should be given to the terms of the deconsolidation transaction and the requirements of ASC 820. For example, the investor should consider the amount of consideration received for the portion sold, the existence and exercise prices of any call or put options, or other terms that provide inputs that should be used to determine fair value. Investors should disclose the fair value of the retained investment and disclose how they determined it, including any objectively verifiable evidence they obtained. See our FRD, *Fair value measurement*, for additional discussion on determining fair value and the required disclosures.

19.4.3.1 Measuring a retained creditor interest

The FASB concluded¹⁰⁶ that the loss of control and the related deconsolidation of a subsidiary or derecognition of a group of assets in the scope of ASC 810-10-40-3A is a significant economic event that changes the nature of the investment held in the subsidiary or group of assets. Therefore, upon deconsolidation, a reporting entity is required to record any remaining noncontrolling investment in the subsidiary or a group of assets in the scope of ASC 810-10-40-3A at fair value. Consistent with this approach, we believe that a loan to the former subsidiary also should be measured at fair value at the deconsolidation date. Thus, any difference between the carrying amount of the loan to the subsidiary and its fair value should be included in the gain or loss calculation upon deconsolidation of the subsidiary.

19.4.3.2 Subsequent accounting for a retained noncontrolling investment

After a subsidiary or group of assets in the scope of ASC 810-10-40-3A is deconsolidated or derecognized, any retained noncontrolling investment is initially recognized at fair value. After initial recognition, the retained investment is subject to other existing accounting literature, as appropriate.

If the retained investment is accounted for as an equity method investment, the former parent would be required to identify and determine the acquisition date fair value of the underlying assets and liabilities of the investee under ASC 323, with certain exceptions. While the former parent would not recognize those identified assets and liabilities, it must track its basis in them (often referred to as memo accounting) to account for the effect of any differences between its basis and the basis recognized by the investee. (See our FRD, *Equity method investments and joint ventures*, for guidance on this accounting.)

If the retained investment is not accounted for as an equity method investment, it is accounted for as an equity security in accordance with other applicable GAAP.

19.4.4 Determine the carrying amount of the noncontrolling interest

The gain or loss calculation upon deconsolidation is affected by the carrying amount of any noncontrolling interest in the former subsidiary.

As discussed in sections 16.1 and 16.1.8, when there is a redeemable noncontrolling interest, a reporting entity may be required to adjust the carrying amount of the redeemable noncontrolling interest after the attribution of profits and losses. However, adjustments to the carrying amount of a redeemable noncontrolling interest from the application of ASC 480-10-S99-3A do not initially enter into the determination of net income. For this reason, the SEC staff believes¹⁰⁷ that the carrying amount of the noncontrolling interest used in the gain or loss or loss calculation should not include any adjustments made to that noncontrolling interest from the application of ASC 480-10-S99-3A. Instead, previously recorded adjustments to the carrying amount of a noncontrolling interest from the application of ASC 480-10-S99-3A should be eliminated in the same manner in which they were initially recorded (that is, by crediting equity of the parent).

See sections 5.10, C.4.2 and Question 4 in section C.7 of our FRD, *Issuer's accounting for debt and equity financings*, for guidance.

¹⁰⁶ Paragraph B54 of FAS 160.

¹⁰⁷ The views of the SEC staff described here are codified in ASC 480-10-S99-3A, paragraph 19, *Deconsolidation of a Subsidiary*.

19.4.5 Determine the carrying amount of the former subsidiary's assets and liabilities

The gain or loss calculation upon deconsolidation is affected by the carrying amount of the assets and liabilities of the former subsidiary (including any accumulated other comprehensive income attributable to the controlling interest).

While this calculation generally is straightforward, certain areas that require particular attention are discussed below.

19.4.5.1 Assignment of goodwill upon a loss of control

See section 3.14 of our FRD, *Intangibles – Goodwill and other*, for guidance on the assignment of goodwill upon the disposal of all or a portion of a reporting unit.

19.4.5.2 Accounting for accumulated other comprehensive income upon a loss of control

Excerpt from Accounting Standards Codification

Consolidation – Overall

Derecognition

810-10-40-4A

When a parent deconsolidates a subsidiary or derecognizes a group of assets within the scope of paragraph 810-10-40-3A, the parent relationship ceases to exist. The parent no longer controls the subsidiary's assets and liabilities or the group of assets. The parent therefore shall derecognize the assets, liabilities, and equity components related to that subsidiary or group of assets. The equity components will include any noncontrolling interest as well as amounts previously recognized in accumulated other comprehensive income. If the subsidiary or group of assets being deconsolidated or derecognized is a **foreign entity** (or represents the complete or substantially complete liquidation of the foreign entity in which it resides), then the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that foreign entity. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

AOCI of a subsidiary or group of assets is attributed to both the controlling and noncontrolling interests. When a parent deconsolidates a subsidiary or group of assets in the scope of ASC 810-10-40-3A, it should derecognize any portion of AOCI attributable to the noncontrolling interests because the underlying assets or liabilities of the former subsidiary or group of assets that generated the AOCI are no longer recorded on the parent's books. While ASC 810 does not specify the treatment of AOCI attributable to the parent, we believe that any AOCI attributable to the parent should be reclassified and included in the gain or loss recognized upon deconsolidation for the same reason (i.e., because the underlying assets or liabilities of the former subsidiary or group of assets that generated the AOCI are no longer recorded on the parent's books).

Other amounts recognized in equity outside of AOCI (e.g., in additional paid in capital) related to changes in ownership interests of a subsidiary that did not result in a loss of control (such as those transactions discussed in section 18) would not be included in determining the gain or loss. These amounts resulted from transactions among shareholders and are not directly attributable to the noncontrolling interest.

19.4.5.2.1 Foreign currency translation adjustments

If a change in ownership interest causes a parent to lose control of a foreign entity in a transaction in the scope of ASC 810-10-40-3A, the parent would deconsolidate the foreign entity in accordance with ASC 810-10-40-5. The parent derecognizes the carrying amount of assets and liabilities, including any noncontrolling interest as well as amounts previously recognized in other comprehensive income (OCI) related to the foreign entity. ASC 810-10-40-4A clarifies that the amounts previously recognized in OCI

that are reclassified and included in the calculation of gain or loss should include any foreign currency translation adjustments (CTA) related to that foreign entity. Refer to ASC 830-30-40 for guidance on derecognizing the CTA recorded in OCI.

ASC 810 and 830 define a foreign entity as an operation (e.g., subsidiary, division, branch, joint venture, etc.) whose financial statements are both (a) prepared in a currency other than the reporting currency of the reporting entity and (b) combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity. Therefore, a foreign entity may differ from a legal entity as defined. See section 1.2.2 of our FRD, *Foreign currency matters*, for further guidance on the definition of a foreign entity.

19.4.6 Income tax considerations related to the loss of control over a subsidiary

See section 12.2.4 of our FRD, *Income taxes*, for discussion of income tax considerations related to the accounting for a loss of control over a subsidiary and section 14.3.3 of our FRD, *Income taxes*, for a change in the status of foreign subsidiaries.

19.4.7 Classification and presentation of a gain or loss upon loss of control

ASC 810 does not provide guidance on where to classify gains or losses in the income statement that result from the deconsolidation of a subsidiary or derecognition of a group of assets in the scope of ASC 810-10-40-3A. As a result, diversity in practice exists as to whether it should be classified as operating or non-operating income.

In practice, some classify these gains or losses as non-operating income. This approach is applied in part because the transaction results in deconsolidation and the operation is no longer part of the reporting entity's primary revenue- and expense-generating activities and it is also consistent with the SEC staff guidance before the issuance of FAS 160. Before FAS 160, the SEC staff articulated its view in SAB Topic 5-H,¹⁰⁸ which stated that "gains (or losses) arising from issuances by a subsidiary of its own stock, if recorded in income by the parent, should be presented as a separate line item in the consolidated income statement without regard to materiality and clearly be designated as non-operating income." While SAB Topic 5-H focused on a situation in which a gain or loss was recognized while control was maintained, its guidance on classifying gains or losses as non-operating income when a transaction is not a part of a reporting entity's primary revenue- and expense-generating activity could also apply to situations when control is lost.

Others in practice present gains and losses resulting from the deconsolidation of a subsidiary or group of assets that is a business in a transaction in the scope of ASC 810-10-40-3A within operating income. This approach is based on the guidance in ASC 360-10-45-5, which addresses the presentation of a gain or loss on the sale of a long-lived asset (disposal group) that is not a discontinued operation.

Regardless of which approach is applied, a reporting entity should disclose where significant gains or losses are classified in the income statement. Also, reporting entities should carefully evaluate the nature of the deconsolidation transaction to determine the proper classification and presentation of related gain or loss and should consistently apply that evaluation. For example, it would not be appropriate to classify gains in operating income and losses in non-operating income for similar transactions. If a gain or loss recognized is from the deconsolidation of a subsidiary or group of assets in the scope of ASC 810-10-40-3A that would be reported as a discontinued operation, the gain or loss should be presented as part of income (loss) from discontinued operations. See our FRD, *Discontinued operations, Accounting Standards Codification 205-20*, for more guidance.

See section 23.3.5 for additional guidance on the presentation and disclosure requirements upon a loss of control of a subsidiary.

¹⁰⁸ The SEC staff rescinded SAB Topic 5-H after FAS 160 was issued.

19.5

Examples

The following examples illustrate the accounting for deconsolidation of a subsidiary that is in the scope of ASC 810-10-40-3A due to changes in a parent's ownership interest that result in a loss of control. Workpaper adjusting entries are numbered sequentially.

Illustration 19-11: Beginning balance sheet

Company P owns 90% of Company S.

Figure 19-1 presents the consolidating workpaper to arrive at the consolidated balance sheet of Company P as of 31 December 20X3. This consolidating workpaper is taken from Figure 18-6 in Illustration 18-15 of section 18.

Figure 19-1: Consolidating workpaper to arrive at consolidated balance sheet, 31 December 20X3 (all amounts in dollars)

	Company P	Company S	Adjustments (1)		Consolidated
			Debit	Credit	
Cash	-	33,000			33,000
Marketable securities	-	17,000			17,000
Inventory	-	34,500			34,500
Buildings and equipment, net	-	85,500			85,500
Investment in Company S	89,357	-		89,357	-
Goodwill	-	4,286			4,286
Total assets	89,357	174,286			174,286
Accounts payable	-	75,000			75,000
Debt	48,000	-			48,000
Total liabilities	48,000	75,000			123,000
Common stock	1,500	25,000	25,000		1,500
Additional paid-in capital	14,357	39,286	39,286		14,357
Accumulated other comprehensive income	4,500	5,000	5,000		4,500
Retained earnings (deficit)	21,000	30,000	30,000		21,000
Total parent shareholders' equity	41,357	99,286			41,357
Noncontrolling interest	-	-		9,929	9,929
Total equity	41,357	99,286			51,286
Total liabilities and equity	89,357	174,286			174,286

19.5.1

Deconsolidation by selling entire interest

Illustration 19-12: Deconsolidation by selling entire interest

Assume that on 1 January 20X4, Company P sells its entire 90% interest in Company S for \$125,000. Company S is a business and the transaction is within the scope of ASC 810.

Company P no longer has a controlling financial interest in the subsidiary. So, Company P derecognizes Company S and calculates its gain as follows:

Cash proceeds	\$ 125,000
Carrying amount of the noncontrolling interest	9,929
AOCI attributable to Company P	<u>4,500</u>
	139,429
Carrying amount of Company S's net assets	<u>(99,286)</u>
Gain	<u>\$ 40,143</u>

On a consolidated basis, Company S's assets, liabilities and noncontrolling interest should be derecognized, and the cash proceeds and gain should be recognized through the following journal entry:

Cash	\$ 125,000	
Noncontrolling interest	9,929	
Accounts payable	75,000	
AOCI	4,500	
Cash (of Company S)		\$ 33,000
Marketable securities		17,000
Inventory		34,500
Buildings and equipment, net		85,500
Goodwill		4,286
Gain on sale of investment		40,143

Alternatively, on a parent-only basis, the investment in Company S and AOCI should be derecognized, and the gain and cash proceeds should be recognized.

Cash	\$ 125,000	
AOCI	4,500	
Investment in Company S		\$ 89,357
Gain on sale of investment		40,143

Figure 19-2 presents Company P's balance sheet at 1 January 20X4, after the sale of Company S.

Figure 19-2: Company P balance sheet, 1 January 20X4, entire interest sold (all amounts in dollars)

	Company P		Adjustments		Company P
			Debit	Credit	
Cash	-	(1)	125,000		125,000
Marketable securities	-				-
Inventory	-				-
Buildings and equipment, net	-				-
Investment in Company S	89,357		(2)	89,357	-
Goodwill	-				-
Total assets	89,357				125,000
Accounts payable	-				-
Debt	48,000				48,000
Total liabilities	48,000				48,000
Common stock	1,500				1,500
Additional paid-in capital	14,357				14,357
Accumulated other comprehensive income	4,500	(2)	4,500		-
Retained earnings (deficit)	21,000		(3)	40,143	61,143
Total parent shareholders' equity	41,357				77,000
	-				-
Total liabilities and equity	89,357				125,000

(1) Cash is rolled forward as follows:

Beginning balance	\$ -
Proceeds from sale	<u>125,000</u>
Ending balance	<u>\$ 125,000</u>

(2) The investment and AOCI are zero after the sale of Company S.

(3) The rollforward of the retained earnings balance is as follows:

Beginning balance	\$ 21,000
Gain from sale of investment	<u>40,143</u>
Ending balance	<u>\$ 61,143</u>

19.5.2

Deconsolidation by selling a partial interest

Illustration 19-13: Deconsolidation by selling a partial interest

Assume that instead of selling its entire interest in Company S on 1 January 20X4, Company P sells a 50% interest in Company S (leaving Company P with a remaining 40% interest) for \$70,000. The fair value of Company P's the remaining 40% interest is \$50,000. The transaction is within the scope of ASC 810-10-40-3A.

In this example, Company P's investment in Company S is recognized at fair value and is reflected as part of the sales proceeds.

Company P's gain is calculated as follows:

Proceeds	\$ 70,000
Fair value of retained noncontrolling interest	50,000
Carrying value of noncontrolling interest	9,929
AOCI attributable to Company P	<u>4,500</u>
	134,429
Carrying amount of Company S's net assets	<u>(99,286)</u>
Gain	<u>\$ 35,143</u>

On a consolidated basis, Company S's assets, liabilities and noncontrolling interest should be derecognized, and the cash proceeds, gain and retained interest in Company S should be recognized through the following journal entry:

Cash	\$ 70,000	
Noncontrolling interest	9,929	
Accounts payable	75,000	
AOCI attributable to Company P	4,500	
Investment in Company S	50,000	
Cash (of Company S)		\$ 33,000
Marketable securities		17,000
Inventory		34,500
Buildings and equipment, net		85,500
Goodwill		4,286
Gain on sale of investment		35,143

Alternatively, on a parent-only basis, the investment in Company S is adjusted to its fair value of \$50,000, the AOCI balance is derecognized, and the gain and cash proceeds are recognized.

Cash	\$ 70,000	
AOCI	4,500	
Investment in Company S		\$ 39,357
Gain on sale of investment		35,143

Figure 19-3 presents Company P's balance sheet at 1 January 20X4, reflecting the sale of Company S.

Figure 19-3 Company P balance sheet, 1 January 20X4, partial interest sold (all amounts in dollars)

	Company P		Adjustments		Company P
			Debit	Credit	
Cash	-	(4)	70,000		70,000
Marketable securities	-				-
Inventory	-				-
Buildings and equipment, net	-				-
Investment in Company S	89,357		(5)	39,357	50,000
Goodwill	-				-
Total assets	89,357				120,000
Accounts payable	-				-
Debt	48,000				48,000
Total liabilities	48,000				48,000
Common stock	1,500				1,500
Additional paid-in capital	14,357				14,357
Accumulated other comprehensive income	4,500	(6)	4,500		-
Retained earnings (deficit)	21,000		(7)	35,143	56,143
Total parent shareholders' equity	41,357				72,000
	-				-
Total liabilities and equity	89,357				120,000

(4) Cash is rolled forward as follows:

Beginning balance	\$ -
Proceeds from sale	<u>70,000</u>
Ending balance	<u>\$ 70,000</u>

(5) The investment in Company S account was adjusted to equal the fair value of the retained interest in Company S at the date of deconsolidation (\$50,000).

(6) AOCI is zero after the sale of Company S and the repayment of Company P's debt.

(7) The rollforward of retained earnings is as follows:

Beginning balance	\$ 21,000
Gain from sale of investment	<u>35,143</u>
Ending balance	<u>\$ 56,143</u>

19.5.3 Deconsolidation as a result of dilution

The following example illustrates the accounting for deconsolidation of a subsidiary that is in the scope of ASC 810-10-40-3A due to a dilution of the parent's ownership interest that results in a loss of control.

Illustration 19-14: Deconsolidation as a result of dilution

Company P (the parent) owns 600,000 of the 1,000,000 shares (or 60%) issued by its subsidiary, Company S. In Company P's consolidated financial statements, the carrying value of Company S's net identifiable assets is \$135 million and the carrying value of the noncontrolling interest is \$48 million.

On 1 January 20X4, Company S issues 500,000 shares to a new investor for \$80 million. As a result, Company P's 600,000 shares now represent 40% of the 1,500,000 shares issued by Company S. The transaction is in the scope of ASC 810-10-40-3A (assume that Company P loses control of Company S and accounts for its retained interest under the equity method).

Company P determines that the fair value of its retained investment in Company S is \$96 million.

Analysis

Company P's gain is calculated as follows:

Fair value of retained equity method investment	\$ 96,000
Carrying value of noncontrolling interest	48,000
Carrying amount of Company S's net assets	<u>(135,000)</u>
Gain	<u>\$ 9,000</u>

Therefore, Company P derecognizes Company S's assets, liabilities and noncontrolling interest and recognizes the gain and retained equity method investment in Company S through the following journal entry:

Equity method investment in Company S	\$ 96,000	
Noncontrolling interest	48,000	
Gain on sale of investment		\$ 9,000
Carrying amount of Company S' net assets (shown here net as a single line item)		135,000

Since Company P does not receive any of the cash proceeds from the share issuance by Company S, that cash is not included in the calculation of the gain or the journal entry recognized by Company P. However, Company P may consider that transaction in determining the fair value of the equity method investment it retained in Company S.

20 Combined financial statements

20.1 Purpose of combined financial statements

Excerpt from Accounting Standards Codification

Consolidation – Overall

Implementation Guidance and Illustrations

810-10-55-1B

To justify the preparation of consolidated financial statements, the controlling financial interest shall rest directly or indirectly in one of the entities included in the consolidation. There are circumstances, however, in which combined financial statements (as distinguished from consolidated financial statements) of commonly controlled entities are likely to be more meaningful than their separate financial statements. For example, combined financial statements would be useful if one individual owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be used to present the financial position and results of operations of entities under common management.

The primary basis for presenting consolidated financial statements is when one entity has a controlling financial interest in another entity. The usual condition for a controlling financial interest is ownership of a majority voting interest as described in the Voting Model but may also exist through other means as described in the Variable Interest Model.

The fundamental difference between combined and consolidated financial statements is that there is no controlling financial interest present between or among the combined entities. ASC 810 does not specify when combined financial statements should be prepared but states that combined financial statements may be useful for entities under common control or common management that have related operations. In these cases, combining the financial statements of entities may be more meaningful than presenting the financial statements of the entities separately. Most often, combined financial statements are presented for filings prepared in accordance with statutory or regulatory requirements.

See section G.4 for SEC staff guidance on when an investment adviser may satisfy the requirements of Rule 206(4)-2(b)(4) under the Investment Advisers Act of 1940 by distributing audited combined financial statements.

Question 20.1

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. A primary beneficiary of a VIE must consolidate the VIE. ASC 810-10-55-1B permits combined financial statements only in certain situations in which consolidated financial statements are not required.¹⁰⁹

¹⁰⁹ AICPA Technical Questions and Answers – Consolidated Versus Combined Financial Statements Under FASB ASC 810, *Consolidation* (TQA 1400.29)

20.1.1 Common operations and management

We believe that the determination of whether entities have related operations and are under common management should be based on individual facts and circumstances. To justify combined presentation, we would expect evidence to exist that indicates the subsidiaries are not operated as if they were autonomous. This evidence could include:

- ▶ A common chief executive officer
- ▶ Common facilities and costs
- ▶ Commitments, guarantees or contingent liabilities among the entities
- ▶ Commonly financed activities

There could be other factors relevant to determining whether subsidiaries have related operations and are under common management.

The following illustration demonstrates these concepts.

Illustration 20-1: Presenting combined versus consolidated financial statements

Company S has 2,000 common shares and 1,000 preferred shares outstanding. The preferred shareholders have the same rights as the common shareholders except that they do not have the right to vote. Half of the 2,000 common shares outstanding are owned by Company P and the other half are owned by an individual who also owns all of the outstanding common shares of Company P and is the CEO of both Company P and Company S. The preferred shares of Company S are owned by a third party. Company P does not control Company S directly or indirectly, and, therefore, consolidation under either the variable interest or voting interest models is not appropriate.

Analysis

Company P and Company S are under common management because the individual that owns Company P also owns half of the voting shares of Company S. Combined financial statements of Company P and Company S could be presented as long as combined statements are more meaningful than presenting the financial statements of Company S separately.

20.2 Preparing combined financial statements

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

810-10-45-10

If **combined financial statements** are prepared for a group of related entities, such as a group of commonly controlled entities, intra-entity transactions and profits or losses shall be eliminated, and **noncontrolling interests**, foreign operations, different fiscal periods, or income taxes shall be treated in the same manner as in consolidated financial statements.

The procedures applied when preparing combined financial statements are the same as those applied when preparing consolidated financial statements. That is, transactions between the entities in the combined presentation and the related profits and losses must be eliminated. Also, the accounting for noncontrolling interests, foreign operations, different fiscal periods and income taxes is the same.

“Noncontrolling interests” in ASC 810-10-45-10 refers to the noncontrolling interests in each of the combining entities’ *subsidiaries* as reflected in each of the combining entities’ financial statements. We believe interests held by parties outside of the control group in each of the respective combining entities themselves would not constitute noncontrolling interests in the combined financial statements. The fundamental difference between combined and consolidated financial statements is that there is no controlling financial interest present between or among the combined entities. Therefore, we believe equity holdings in each of the combining entities, regardless of who holds this equity (that is, whether the equity is held by parties outside of the control group or not) should be reflected as ownership interests in the combined financial statements.

Illustration 20-2: Noncontrolling interests in combined financial statements

Company P consolidates Subsidiaries A, B and C. None of these subsidiaries are wholly owned. Subsidiary A also owns 80% of its subsidiary (Subsidiary A1) and the remaining 20% noncontrolling interest is held by a third party. Combined financial statements are prepared for Subsidiaries A and B.

Analysis

The 20% noncontrolling interest held by the third party in Subsidiary A1 would be reflected as noncontrolling interest in the combined financial statements of Subsidiaries A and B. The noncontrolling interests held in Subsidiaries A and B themselves would not constitute noncontrolling interests in the combined financial statement and would be reflected as ownership interests.

21 Parent-company financial statements

21.1 Purpose of parent-company financial statements

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

810-10-45-11

In some cases parent-entity financial statements may be needed, in addition to consolidated financial statements, to indicate adequately the position of bondholders and other creditors or preferred shareholders of the parent. Consolidating financial statements, in which one column is used for the parent and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information. However, consolidated financial statements are the general-purpose financial statements of a parent having one or more subsidiaries; thus, parent-entity financial statements are not a valid substitute for consolidated financial statements.

Parent-company financial statements present the results of operations and financial position of a parent entity on a stand-alone basis. ASC 810 permits the presentation of parent-company financial statements but clarifies that these financial statements may not be issued as the primary financial statements of the reporting entity and are not a valid substitute for consolidated financial statements. That is, parent-company financial statements should be presented along with consolidated financial statements.

Certain SEC registrants must present condensed parent-company financial information under Regulation S-X, Rule 12-04, *Condensed Financial Information of Registrant*, in Schedule I of their Form 10-K. This schedule is required when restricted net assets of consolidated subsidiaries exceed 25% of consolidated net assets at the end of the fiscal year. Registrants are required to present information required by Rule 12-04 as a separate schedule or in the notes to the financial statements. Our publication, *SEC annual reports – Form 10-K*, provides more guidance for applying these quantitative tests and summarizes the related disclosure requirements. See our publication, *SEC annual reports – Form 10-K*, for additional guidance on parent company financial statements.

Not-for-profit entities¹¹⁰ such as health care providers also occasionally prepare parent-company financial statements. Consolidation with respect to not-for-profit entities is addressed in ASC 958.

¹¹⁰ ASC 810-10-20 defines a not-for-profit entity as “(a) an entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity: (a) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (b) operating purposes other than to provide goods or services at a profit, (c) absence of ownership interests like those of business entities. Entities that clearly fall outside this definition include the following: (a) all investor-owned entities and (b) entities that provide dividends, lower costs or other economic benefits directly and proportionately to their owners, members or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives and employee benefit plans.”

21.1.1 Investments in subsidiaries

Parent-company financial statements generally present the parent company's investment in consolidated subsidiaries under the equity method in accordance with ASC 323. Under ASC 805 and ASC 810, additional investment activity in consolidated subsidiaries that does not result in a change in control is accounted for as an equity transaction. It's important to note that because ASC 323 uses step-acquisition accounting, basis differences may exist between the application of the equity method and the parent's proportion of the subsidiary's equity.

This accounting is not specifically addressed by the accounting literature. Therefore, we believe a parent that does not apply the equity method to their investments in consolidated subsidiaries and instead determines the value at an amount equal to its proportionate share of the carrying amount of the subsidiaries' net assets should continue this practice. Otherwise, the equity and earnings of the parent company in the parent-company financial statements may differ from the corresponding amounts in the consolidated financial statements.

21.1.2 Investments in non-controlled entities

Investments accounted for as financial assets or under the equity method in consolidated financial statements should follow that same basis in the parent-company financial statements. Also, their carrying amounts should generally be the same on the parent-company financial statements and the consolidated financial statements.

21.1.3 Disclosure requirements

When parent-company financial statements are presented but are not the primary financial statements of the reporting entity, the notes to the financial statements should include a statement to that effect. In addition, the accounting policy note should describe the policy used to account for investments in subsidiaries. The following is an example of such a note.

Illustration 21-1: Accounting policy note in parent-company financial statements

Note A – Accounting Policies

Basis of Presentation. In the parent-company financial statements, the Company's subsidiaries are accounted for using the equity method. Parent-company financial statements should be read in conjunction with the Company's consolidated financial statements.

22 Consolidating financial statements

22.1 Purpose of consolidating financial statements

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters

810-10-45-11

In some cases parent-entity financial statements may be needed, in addition to consolidated financial statements, to indicate adequately the position of bondholders and other creditors or preferred shareholders of the parent. Consolidating financial statements, in which one column is used for the parent and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information. However, consolidated financial statements are the general-purpose financial statements of a parent having one or more subsidiaries; thus, parent-entity financial statements are not a valid substitute for consolidated financial statements.

Generally, consolidating financial statements present the operating results, financial position and cash flows of a parent and each of its subsidiaries (or groups of subsidiaries) on a standalone basis in separate columns. Consolidating adjustments (e.g., elimination entries) and consolidated totals also are presented in separate columns.

Reporting entities present consolidating financial statements for many reasons, including as supplementary information to the entity's consolidated financial statements for the benefit of certain financial statement users (e.g., management, banks, preferred shareholders).

In March 2020, the SEC simplified the requirements for companies that conduct registered debt offerings with subsidiaries as either issuers or guarantors and affiliates whose securities are pledged as collateral under Rule 3-10 of Regulation S-X. The SEC replaced the requirement for certain registrants to provide condensed consolidating financial statements with a requirement to provide abbreviated disclosures, including summarized financial information and certain non-financial disclosures. The rule became effective 4 January 2021. See section 2.5.3.1 of the SEC Manual, section 6.6 of our publication, *SEC annual reports – Form 10-K* and our Technical Line, *How to apply the SEC's new requirements for registered debt issued or guaranteed by subsidiaries*, for guidance.

The rest of this section provides guidance for when reporting entities present consolidating financial statements for reasons other than to comply with Rule 3-10. Although this guidance is based on the previous requirements of Rule 3-10 and our experience applying those rules, we believe it may be informative for reporting entities that present consolidating financial statements for other reasons.

22.2 Form and content of consolidating financial statements

Consolidating financial statements should be presented in sufficient detail to allow users to determine the assets, results of operations and cash flows of the consolidating groups. We believe it may often be acceptable for companies to prepare their consolidating financial information on a condensed basis.¹¹¹

Consolidating financial statements generally should be presented for the same periods as the consolidated financial statements. The consolidating financial statements generally also should include a total for comprehensive income presented in either a single continuous statement or in two separate but consecutive statements, following the requirements of ASC 220.

The columns used in consolidating financial statements should be based on the information necessary for users of the financial statements, which depends on the facts and circumstances. For example, consolidating financial statements may be prepared on a legal entity basis (e.g., for lenders). In this case, the legal entities should be grouped in the separate columns based on the terms of the agreements. An entity's legal department may need to verify that the groupings of legal entities by column are appropriate. Careful consideration should be given to how changes in an entity's structure should be reflected.

Consolidating (elimination) adjustments generally are presented in a separate column to arrive at total consolidated amounts, which should reconcile to the consolidated financial statements. See section 22.4 for example condensed consolidating financial information.

22.2.1 Intercompany and other adjustments

In consolidating financial statements, reporting entities may need to identify the following:

- ▶ Adjustments to reflect activity on a legal entity basis
- ▶ Adjustments to push down the parent's basis in a subsidiary's assets and liabilities, including any goodwill and noncontrolling interest recognized as a result of the acquisition of such subsidiary (to the extent permitted or required in ASC 805-50)
- ▶ Adjustments to properly classify intercompany balances, including investments in subsidiary accounts, intercompany payables and receivables, and intercompany debt
- ▶ Allocations of certain costs incurred by the parent on behalf of its subsidiaries
- ▶ Adjustments to allocate the effects of certain intercompany elimination entries to the controlling and noncontrolling interest in the parent and subsidiary columns

For internal reporting, entities often group financial information by region, product line, brand or industry, but not by legal entity. Therefore, adjustments may be required when preparing consolidating financial statements on a legal entity basis to ensure each column reflects the appropriate balances.

Assets and liabilities (e.g., intellectual property intangibles) should be allocated to the subsidiary that has legal title to them. In addition, when a subsidiary elects to apply pushdown accounting in its separate financial statements, adjustments may be required to "push down" the parent's basis in the net assets of a subsidiary to the applicable subsidiary column. Entities should refer to ASC 805-50 and Appendix B of our FRD, *Business combinations*, for further guidance.

¹¹¹ Our view is based on the guidance that was in Article 10 of Regulation S-X, Rule 3-10(i), which although superseded, provided an indicator as to what may be useful to users of consolidating financial statements.

Adjustments may be required to properly reflect intercompany balances. One common example is when a parent entity performs a treasury function on behalf of its subsidiaries and routinely transfers cash to and from the subsidiaries. Many times, there is no formal policy for recording these transactions for internal reporting purposes. These transactions may be recorded inconsistently (e.g., as intercompany loans, intercompany payables and receivables, or as adjustments to the subsidiary's equity and investment in subsidiary accounts).

Making adjustments to properly reflect intercompany transactions in the consolidating financial statements may require a detailed evaluation of the nature of the transactions. For example, interest-bearing assets should be recorded as loans, and the terms of the loans should be evaluated to determine whether short-term or long-term classification is appropriate. Related adjustments to properly reflect intercompany interest income and charges also may be required. Assets and liabilities that are noninterest bearing should be evaluated to determine if they relate to capital transactions that should be recorded within equity. The individual columns in the consolidating financial statements should be in accordance with GAAP. For example, intercompany receivables or liabilities should be classified as current or long-term assets or liabilities, rather than as liabilities with debit balances or assets with credit balances.

Depending on the purpose of the consolidating financial statements, a reporting entity may want to consider the guidance in SAB Topic 1.B.1 (codified in ASC 220-10-S99-3) for allocating charges incurred by a parent on behalf of a subsidiary. This includes costs incurred by the parent that are directly attributable to the subsidiary's operations and the subsidiary's allocable share of other corporate costs.

See section 22.2.2 for guidance on how a parent may account for its equity in a subsidiary's earnings or losses and rolls forward its investment in that subsidiary. Once all adjustments are posted, the following are examples of accounts that should reconcile to each other, if presented separately in the consolidating financial statements:

- ▶ Intercompany payables and intercompany receivables
- ▶ Intercompany income and intercompany charges
- ▶ Equity of the parent and consolidated equity attributable to the controlling interest
- ▶ Earnings of the parent and consolidated earnings attributable to the controlling interest
- ▶ Parent's equity in the earnings of a subsidiary and earnings of the subsidiary attributable to the controlling interest
- ▶ Parent's investment in subsidiary balance and equity of the subsidiary attributable to the controlling interest
- ▶ Cash flow activity relating to intercompany transactions

See the example in section 22.4 for an illustration of accounts that reconcile.

22.2.2 Investments in subsidiaries

In consolidating financial statements, a reporting entity may present the parent's investments in its subsidiaries under the equity method in accordance with ASC 323, based upon its proportionate share of each subsidiary's net assets in the parent company column. In this case, the reporting entity also should present any investments held by subsidiaries in lower-tier subsidiaries in other columns in the same manner.

If the equity method is used to account for a parent's interest in its subsidiaries in the consolidating financial statements, then consistent with the methodology in ASC 323, investments in subsidiaries are initially recognized based on the consideration transferred to obtain control of the subsidiary. The balance is subsequently adjusted for changes in ownership that do not result in a loss of control, subsidiary earnings or losses, the effects of elimination entries attributable to the controlling interest, intercompany dividends, and other items that result in changes to the net assets of the subsidiary (e.g., contributions of assets by the parent). The investment in subsidiary balance generally eliminates against equity of the subsidiary attributable to the controlling interest in consolidation.

Illustration 22-1 provides an example rollforward of an investment in subsidiary account to highlight the common types of adjustments.

Illustration 22-1: Rollforward of an investment in subsidiary account

On 1 January 20X1, Parent acquires a 100% controlling financial interest in Subsidiary A for \$100,000.

On 28 February 20X1, Parent transfers fixed assets with a carrying value of \$10,000 to Subsidiary A.

On 31 March 20X1, Parent sells 10% of its interest in Subsidiary A to a third party but retains control.

On 30 November 20X1, Parent sells inventory to Subsidiary A (downstream transaction) that Subsidiary A holds at year-end. Parent recognizes \$10,000 of revenues on the transaction and \$8,000 in cost of revenues for a net profit of \$2,000. At year-end, the \$2,000 in net profit is eliminated in consolidation and the elimination is attributable entirely to the controlling interest.

For fiscal year 20X1, Subsidiary A has net income of \$60,000, other comprehensive income of \$10,000, which were earned ratably throughout the year (i.e., \$5,000 and \$833 per month, respectively). Subsidiary A declared a cash dividend of \$20,000 at year-end to its shareholders.

The carrying amount of the net assets of Subsidiary A at 31 December 20X1 is \$160,000, excluding the effects of any eliminations.

Analysis

Included below is a rollforward of Parent's Investment in Subsidiary A account for fiscal year 20X1 using the equity method:

Beginning balance (31 December 20X0)	\$ -
Acquire 100% of Subsidiary A (1 January 20X1)	100,000
Transfer fixed assets to Subsidiary A (28 February 20X1)	10,000
Equity in net income of Subsidiary A for three months ended 31 March 20X1 (1)	15,000
Equity in other comprehensive income of Subsidiary for three months ended 31 March 20X1 (1)	2,500
Sell 10% of Subsidiary A stock (31 March 20X1) (1)	(12,750)
Equity in net income of Subsidiary A for the nine months ended 31 December 20X1 (2)	40,500
Equity in other comprehensive income for the nine months ended 31 December 20X1 (3)	6,750
Dividend from Subsidiary A to Parent (90%)	(18,000)
Elimination of intercompany profit (100%)	(2,000)
Ending balance (31 December 20X1)	<u>\$ 142,000</u>

The ending balance of Parent's Investment in Subsidiary A account for fiscal year 20X1 equals its proportionate share of the net assets of Subsidiary A (i.e., $\$144,000 = \$160,000 \times 90\%$), less the effects of the elimination of intercompany profit attributable to the controlling interest ($\$2,000$).

- (1) Reflects the decrease in the investment account when the noncontrolling interest was created upon the sale of 10% of Subsidiary A's stock. At the time of the sale, Subsidiary A's equity was $\$127,500$ ($\$100,000 + \$10,000 + \$15,000$ of net income and $\$2,500$ of other comprehensive income). The net income and other comprehensive income were earned ratably over the year ($(3 \text{ months} \times \$5,000 \times 100\%) + (3 \text{ months} \times \$833 \times 100\%)$). Therefore, the investment balance decreased by $\$12,750$ ($10\% \times \$127,500$).
- (2) Assumes Subsidiary A's annual net income of $\$60,000$ was earned ratably over the 12-month period ($9 \text{ months} \times \$5,000 \times 90\%$).
- (3) Assumes Subsidiary A's other comprehensive income of $\$10,000$ was earned ratably over the 12-month period ($9 \text{ months} \times \$833 \times 90\%$).

22.2.3

Cash flow information

To prepare a consolidating cash flow statement, reporting entities generally begin with the amounts in the consolidating balance sheet and income statement. General ledger balances often do not include the adjustments needed when preparing the consolidating financial statements described in section 22.2.1. We believe cash flows from operating activities can be presented net (i.e., as a single line item).¹¹²

Reporting entities should classify intercompany activity appropriately in the parent and subsidiary columns in the consolidating cash flow statements, which requires a careful evaluation of the facts and circumstances. Examples of common intercompany cash flow activity that should be evaluated carefully to determine the appropriate classification include:

- ▶ Cash flow activity related to intercompany payables/receivables
- ▶ Cash flow activity related to the parent's investment in subsidiary, including intercompany dividend activity
- ▶ Intercompany borrowing and repayment activity
- ▶ Intercompany capital contributions
- ▶ Purchases, sales and transfers of fixed and other assets among affiliates

There is a common misconception that all intercompany activity is an operating activity when some intercompany transactions may relate to investing or financing activities or may be a noncash activity. For example, a subsidiary that either receives or pays back intercompany loans or other advances from the parent (or another subsidiary) classifies those transactions as financing activities. The parent or other subsidiary providing the loans or other advances classifies the transactions as investing activities.

Cash flow activity related to the parent's investment in a subsidiary also generally requires adjustments to present the activity correctly. For example, a parent's initial investment in the subsidiary is classified as an investing activity by the parent and as a financing activity by the subsidiary. Further, the parent evaluates dividends received from the subsidiary to determine whether they are a return on the investment (classified as operating activities) or a return of the investment (classified as investing activities). The subsidiary classifies all dividend payments as financing activities.

¹¹² Our view is based on the guidance in Article 10-01(a)(4) of Regulation S-X.

See section 5.4.2 of our FRD, *Statement of cash flows*, for further guidance on the classification of items on the statement of cash flows. See section 22.4 for an example of consolidating cash flow statements.

22.3

Disclosures for consolidating financial statements

Reporting entities that present consolidating financial statements should disclose information that is relevant for users to understand the allocation of the assets, results of operations and cash flows of the different groups presented in the consolidating financial statements, which will vary depending on the facts and circumstances and purpose of the consolidating financial statements. This information may include, for example:

- ▶ The ownership of guarantor subsidiaries
- ▶ If any guarantees are full and unconditional, and joint and several
- ▶ Any restrictions on the ability of the parent or any guarantor to obtain funds from its subsidiaries by dividend or loan
- ▶ Any restrictions on the ability of subsidiaries to transfer cash to the parent in through dividends, loans or advances (e.g., borrowing arrangements, regulatory restraints, foreign government)
- ▶ Any restricted net assets of subsidiaries

22.4

Example consolidating financial statements

Illustration 22-2: Consolidating statements of income					
Consolidating statements of income					
Year ended 31 December 20X1 (all amounts in dollars)					
	Parent	Subsidiary guarantor	Non- guarantors	Eliminations	Consolidated
Net sales	-	2,250	1,000	(100)	3,150
Cost of goods sold	-	1,250	500	(100)	1,650
Gross profit	-	1,000	500	-	1,500
Selling, distribution, and administrative expenses	125	525	375	-	1,025
Operating profit	(125)	475	125	-	475
Interest expense	(80)	(1) (15)	-	15	(80)
Interest income	(1) 15	-	-	(15)	-
Intercompany expense	-	(2) (125)	(2) (25)	150	-
Intercompany income	(2) 150	-	-	(150)	-
Income before income taxes and equity in net income of subsidiaries	(40)	335	100	-	395
Income taxes	14	(120)	(35)	-	(141)
Income before equity in net income of subsidiaries	(26)	215	65	-	254
Equity in net income of subsidiaries	(3) 267	-	-	(267)	-
Net income	241	215	65	(267)	254
Net income attributable to noncontrolling interest	-	-	13	-	13
Net income attributable to parent	(4) 241	(3) 215	(3) 52	(267)	(4) 241
Comprehensive income	297	255	85	(323)	314
Comprehensive income attributable to noncontrolling interest	-	-	17	-	17
Comprehensive income attributable to parent	297	255	68	(323)	297

The following amounts in the consolidating statements of income above reconcile to one another (consistent with the guidance described in section 22.2.1):

- (1) Intercompany interest income of the Parent (\$15) equals intercompany interest expense recognized by the Subsidiary Guarantor (\$15).
- (2) Intercompany income of the Parent (\$150) equals the intercompany expense recognized by the subsidiaries (\$125 + \$25 = \$150).
- (3) Parent's equity in net income of subsidiaries (\$267) equals the total net income attributable to Parent in the subsidiary columns (\$215 + \$52 = \$267).
- (4) Parent's net income (\$241) equals the consolidated net income attributable to the Parent (\$241).

Illustration 22-3: Consolidating statements of income

Consolidating statements of income					
Year ended 31 December 20X2 (all amounts in dollars)					
	Parent	Subsidiary guarantor	Non- guarantors	Eliminations	Consolidated
Net sales	-	3,250	1,525	(200)	4,575
Cost of goods sold	-	1,850	875	(200)	2,525
Gross profit	-	1,400	650	-	2,050
Selling, distribution, and administrative expenses	150	675	375	-	1,200
Operating profit	(150)	725	275	-	850
Interest expense	(95)	(5) (25)	-	25	(95)
Interest income	(5) 25	-	-	(25)	-
Intercompany expense	-	(6) (145)	(6) (45)	190	-
Intercompany income	(6) 190	-	-	(190)	-
Income before income taxes and equity in net income of subsidiaries	(30)	555	230	-	755
Income taxes	12	(120)	(90)	-	(198)
Income before equity in net income of subsidiaries	(18)	435	140	-	557
Equity in net income of subsidiaries	(7) 547	-	-	(547)	-
Net income	529	435	140	(547)	557
Net income attributable to noncontrolling interest	-	-	28	-	28
Net income attributable to parent	(8) 529	(7) 435	(7) 112	(547)	(8) 529
Comprehensive income	603	485	170	(621)	637
Comprehensive income attributable to noncontrolling interest	-	-	34	-	34
Comprehensive income attributable to parent	603	485	136	(621)	603

The following amounts in the consolidating statements of income above reconcile to one another (consistent with the guidance described in section 22.2.1):

- (5) Intercompany interest income of the Parent (\$25) equals intercompany interest expense recognized by the Subsidiary Guarantor (\$25).

- (6) Intercompany income of the Parent (\$190) equals the intercompany expense recognized by the subsidiaries (\$145 + \$45 = \$190).
- (7) Parent's equity in net income of subsidiaries (\$547) equals the total net income attributable to the Parent in the subsidiary columns (\$435 + \$112 = \$547).
- (8) Parent's net income (\$529) equals consolidated net income attributable to the Parent (\$529).

Illustration 22-4: Consolidating balance sheets

Consolidating balance sheets						
31 December 20X1 (all amounts in dollars)						
	Parent	Subsidiary guarantor	Non-guarantors	Eliminations	Consolidated	
Assets						
Current assets:						
Cash and cash equivalents	375	5	45	-	425	
Accounts receivable, net	-	235	50	-	285	
Intercompany receivables	(9) 50	(9) 50	(9) 10	(110)	-	
Inventories	-	200	90	-	290	
Other current assets	5	25	15	-	45	
Total current assets	430	515	210	(110)	1,045	
Property, plant, and equipment, net	-	125	30	-	155	
Goodwill	-	300	45	-	345	
Intangible assets	-	95	5	-	100	
Investments in subsidiaries	(10) 466	-	-	(466)	-	
Total assets	896	1,035	290	(576)	1,645	
Liabilities and stockholders' equity						
Current liabilities:						
Accounts payable	10	275	15	-	300	
Intercompany payable	(9) 5	(9) 80	(9) 25	(110)	-	
Other accrued liabilities	15	240	15	-	270	
Total current liabilities	30	595	55	(110)	570	
Long-term debt	300	-	-	-	300	
Deferred income taxes	-	150	15	-	165	
Stockholders' equity:						
Total parent's stockholders' equity	(11) 566	(10) 290	(10) 176	(466)	(11) 566	
Noncontrolling interest	-	-	44	-	44	
Total stockholders' equity	566	290	220	(466)	610	
Total stockholders' equity and liabilities	896	1,035	290	(576)	1,645	

The following amounts in consolidating balance sheets above reconcile to one another (consistent with the guidance described in section 22.2.1):

- (9) Total intercompany receivables (\$50 + \$50 + \$10 = \$110) equal total intercompany payables (\$5 + \$80 + \$25 = \$110).
- (10) The Parent's investment in subsidiaries (\$466) equals total equity of the subsidiaries attributable to the Parent (\$290 + \$176 = \$466).
- (11) The Parent's equity (\$566) equals consolidated equity attributable to the Parent (\$566).

Illustration 22-5: Consolidating balance sheets

Consolidating balance sheets						
31 December 20X2 (all amounts in dollars)						
	Parent	Subsidiary guarantor	Non- guarantors	Eliminations	Consolidated	
Assets						
Current assets:						
Cash and cash equivalents	267	90	40	-	397	
Accounts receivable, net	-	378	120	-	498	
Intercompany receivables	(12) 100	(12) 60	(12) 15	(175)	-	
Inventories	-	375	200	-	575	
Other current assets	5	20	35	-	60	
Total current assets	372	923	410	(175)	1,530	
Property, plant, and equipment, net	-	120	29	-	149	
Goodwill	-	300	45	-	345	
Intercompany notes receivable	(13) 225	-	-	(225)	-	
Intangible assets	-	90	5	-	95	
Investments in subsidiaries	(14) 937	-	-	(937)	-	
Total assets	1,534	1,433	489	(1,337)	2,119	
Liabilities and stockholders' equity						
Current liabilities:						
Accounts payable	5	218	35	-	258	
Intercompany payable	(12) 60	(12) 105	(12) 10	(175)	-	
Other accrued liabilities	-	95	25	-	120	
Total current liabilities	65	418	70	(175)	378	
Long-term debt	300	-	-	-	300	
Intercompany notes payable	-	(13) 225	-	(225)	-	
Deferred income taxes	-	165	29	-	194	
Stockholders' equity:						
Total parent's stockholders' equity	(15) 1,169	(14) 625	(14) 312	(937)	(15) 1,169	
Noncontrolling interests	-	-	78	-	78	
Total stockholders' equity	1,169	625	390	(937)	1,247	
Total stockholders' equity and liabilities	1,534	1,433	489	(1,337)	2,119	

The following amounts in the consolidating balance sheets above reconcile to one another (consistent with the guidance described in section 22.2.1):

- (12) Total intercompany receivables ($\$100 + \$60 + \$15 = \175) equal total intercompany payables ($\$60 + \$105 + \$10 = \175).
- (13) Intercompany notes receivable ($\$225$) equal intercompany notes payable ($\$225$).
- (14) The parent's investment in subsidiaries account ($\$937$) equals total equity of subsidiaries attributable to the parent ($\$625 + \$312 = \$937$). Also, the roll forward of this account is as follows:
- | | |
|---|---------------|
| Beginning balance (Illustration 22-4) | \$ 466 |
| Share of comprehensive income of subsidiary guarantor (Illustration 22-3) | 485 |
| Share of comprehensive income of subsidiary non-guarantor (Illustration 22-3) | 136 |
| Dividends received from subsidiary guarantor (Illustration 22-6) | (150) |
| Ending balance | <u>\$ 937</u> |
- (15) The Parent's equity ($\$1,169$) equals consolidated equity attributable to the Parent ($\$1,169$).

Illustration 22-6: Consolidating statements of cash flows

Consolidating statements of cash flows						
Year ended 31 December 20X1 (all amounts in dollars)						
	Parent	Subsidiary guarantor	Non-guarantors	Eliminations		Consolidated
Net cash provided by (used in) operating activities	25	25	40	(17)	(150)	(60)
Cash provided by (used in) investing activities:						
Purchases of property, plant, and equipment	-	(5)	-	-	-	(5)
Net cash used in investing activities	-	(5)	-	-	-	(5)
Cash provided by (used in) financing activities:						
Issuance of long-term debt	300	-	-	-	-	300
Intercompany dividends	-	(16)	(150)	-	(17)	150
Net cash (used in) provided by financing activities	300	(150)	-	150	-	300
Net change in cash and cash equivalents	325	(130)	40	-	-	235
Cash and cash equivalents at beginning of year	50	135	5	-	-	190
Cash and cash equivalents at end of year	375	5	45	-	-	425

The following intercompany amounts have been separately classified in the consolidating statements of cash flows above (consistent with the guidance described in section 22.2.3):

- (16) Intercompany dividends paid to the Parent are classified as cash used in financing activities by the Subsidiary Guarantor.
- (17) The Parent classifies the intercompany dividends received from the Subsidiary Guarantor as operating activities since they are a return on the investment. Since cash provided by (or used in) operating activities is presented at a net amount as a single line item, the intercompany dividends received are not reflected separately here. They eliminate against the intercompany dividend activity in Item (16) in consolidation.

Illustration 22-7: Consolidating statements of cash flows

Consolidating statements of cash flows						
Year ended 31 December 20X2 (all amounts in dollars)						
	Parent	Subsidiary guarantor	Non-guarantors	Eliminations		Consolidated
Net cash provided by (used in) operating activities	117	15	(5)	(20)	(150)	(23)
Cash provided by (used in) investing activities:						
Intercompany notes issued	(18)	(225)	-	-	(18)	225
Purchases of property, plant, and equipment	-	(5)	-	-	-	(5)
Net cash used in investing activities	(225)	(5)	-	-	225	(5)
Cash provided by (used in) financing activities:						
Intercompany notes borrowing	-	(18)	225	-	(18)	(225)
Intercompany dividends	-	(19)	(150)	-	(20)	150
Net cash (used for) provided by financing activities	-	75	-	(75)	-	-
Net change in cash and cash equivalents	(108)	85	(5)	-	-	(28)
Cash and cash equivalents at beginning of year	375	5	45	-	-	425
Cash and cash equivalents at end of year	267	90	40	-	-	397

The following intercompany amounts have been separately classified in the consolidating statements of cash flows above (consistent with the guidance described in section 22.2.3):

- (18) As reflected in Illustration 22-5, the Parent issued intercompany notes to the Subsidiary Guarantor in 20X2. The Parent classifies the issuance of the intercompany notes as cash used for investing activities. The Subsidiary Guarantor classifies the borrowing as cash provided by financing activities. These amounts are eliminated in consolidation.
- (19) Intercompany dividends paid to the Parent are classified as cash used in financing activities by the Subsidiary Guarantor.
- (20) The Parent classifies the intercompany dividends received from the Subsidiary Guarantor as operating activities since they are a return on the investment. Since cash provided by (or used in) operating activities is presented at a net amount as a single line item, the intercompany dividends received are not reflected separately here. They eliminate against the intercompany dividend activity in Item (19) in consolidation.

23 Presentation and disclosures

23.1 Presentation of VIEs

Excerpt from Accounting Standards Codification

Consolidation – Overall

Other Presentation Matters – Variable Interest Entities

810-10-45-25

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

- a. Assets of a consolidated **variable interest entity** (VIE) that can be used only to settle obligations of the consolidated VIE
- b. Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

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 rejected¹¹³ 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.

The presentation and disclosure requirements in the general subsections of ASC 810, which are described in section 23.3, apply to both voting interest entities and VIEs.

Question 23.1

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 23.2.6). 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

¹¹³ Paragraph A81 of FAS 167.

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 23.2

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 23.1), 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 23-1: 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:

Assets	
Cash	\$ 100
Accounts receivable	200
PP&E – net	300
Total assets	<u>\$ 600</u>
Liabilities and equity	
Accounts payable	\$ 150
Long-term debt	400
Equity	50
Total liabilities and equity	<u>\$ 600</u>

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.

23.2 Disclosures for VIEs

All reporting entities with variable interests in VIEs are subject to the disclosure requirements of ASC 810. A parent that consolidates or deconsolidates a VIE also is subject to the presentation and disclosure requirements in the general subsections of ASC 810, which are described in section 23.3.

23.2.1 Disclosure objectives

Excerpt from Accounting Standards Codification

Consolidation – Overall

Disclosure – Variable Interest Entities

810-10-50-2AA

The principal objectives of this Subsection's required disclosures are to provide financial statement users with an understanding of all of the following:

- a. The significant judgments and assumptions made by a reporting entity in determining whether it must do any of the following:
 1. Consolidate a **variable interest entity** (VIE)
 2. Disclose information about its involvement in a VIE.
- b. The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by a reporting entity in its statement of financial position, including the carrying amounts of such assets and liabilities.
- c. The nature of, and changes in, the risks associated with a reporting entity's involvement with the VIE.
- d. How a reporting entity's involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows.

810-10-50-2AB

A reporting entity shall consider the overall objectives in the preceding paragraph in providing the disclosures required by this Subsection. To achieve those objectives, a reporting entity may need to supplement the disclosures otherwise required by this Subsection, depending on the facts and circumstances surrounding the VIE and a reporting entity's interest in that VIE.

810-10-50-2AC

The disclosures required by this Subsection may be provided in more than one note to the financial statements, as long as the objectives in paragraph 810-10-50-2AA are met. If the disclosures are provided in more than one note to the financial statements, the reporting entity shall provide a cross reference to the other notes to the financial statements that provide the disclosures prescribed in this Subsection for similar entities.

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.

See our publication, *SEC annual reports – Form 10-K*, for guidance on the disclosure of off-balance sheet arrangements.

23.2.2 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 23.2.4). However, there is 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.

23.2.3

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 23.2.4). Also, see section 23.2.6 for guidance on aggregating certain disclosures.

Question 23.3

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.

23.2.4

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 810-10-25-49 through 25-54 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 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 23.2.6 for guidance on aggregating certain disclosures.

23.2.5 Scope-related VIE 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 ASC 810-10-50-6. See section 4.4.3 for further guidance on this scope exception.

Further, as described in section 4.3.4, a reporting entity is 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 1940 Act. If a reporting entity uses this scope exception, it is required to provide the disclosures in ASC 810-10-15-12(f). See sections 4.3 and 4.3.4 for further guidance on this scope exception and the required disclosures.

23.2.6 Aggregation of certain VIE 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.

810-10-50-10

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

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.

23.2.7 Public company VIE disclosure requirements

A public company is required to provide disclosure 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.

The SEC staff has stated that these disclosures include obligations arising out of all variable interests in entities, even variable interests in entities that are outside the scope of the Variable Interest Model¹¹⁴ or entities that are determined not to be VIEs after applying the Variable Interest Model. 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.

Off-balance sheet arrangements include:

- ▶ 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

See our publication, *SEC annual reports – Form 10-K*, for more information on the disclosure requirements of off-balance sheet arrangements.

23.2.8 Private company accounting alternative

Private companies can elect an accounting policy to be exempt from applying the Variable Interest Model to common control arrangements that meet certain criteria, but are subject to specific disclosure requirements. See section E.5 for further information.

23.2.9 Measurement alternative for consolidated collateralized financing entities

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.

¹¹⁴ See Section 9230.1 of the SEC staff's Division of Corporation Finance *Financial Reporting Manual*.

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.

A reporting entity that elects the measurement alternative is required to disclose for the CFE's financial assets and financial liabilities the information required by ASC 820 on fair value measurements and ASC 825 on financial instruments. Although the measurement of the less observable amount is technically not at fair value, the fair value measurement disclosures under ASC 820 are required. For the less observable fair value, the reporting entity also must disclose that the amount was measured on the basis of the more observable fair value. These disclosure requirements don't apply to financial assets and financial liabilities that are incidental to the operations of the CFE and have carrying amounts that approximate fair value.

A reporting entity will have to use judgment to determine which level of the fair value hierarchy is appropriate for the less observable amount. See section 13.5.1 for further information.

23.2.10**Wholly foreign-owned enterprises, including China-based issuers (added August 2022)**

The SEC and its staff continue to focus on disclosures by certain Chinese companies, sometimes referred to as wholly foreign-owned enterprises (WFOEs). In this context, WFOEs are offshore holding companies (e.g., those based in the Cayman Islands) set up by China-based operating companies to issue stock to public shareholders in the US. The offshore holding company often consolidates the China-based operating company under the VIE model through a contractual arrangement, because the holding company is the primary beneficiary of the China-based operating company.

SEC Chair Gary Gensler issued a statement¹¹⁵ in July 2021 asking for more disclosures about WFOEs, and the SEC's Division of Corporation Finance posted a sample "Dear CFO" comment letter¹¹⁶ on the SEC's website in December 2021. The statement and sample comment letter highlighted the need for specific disclosures in SEC filings outside of the financial statements. However, some of the points raised in the letter, as summarized below, also may be required financial statement disclosures, as discussed above throughout section 23.2 and in ASC 810-10-50-1 through ASC 810-10-50-10.

In the sample comment letter, the SEC staff asked the registrant to disclose the following information, among other items, as applicable:

- ▶ The registrant is a holding company with operations conducted through contractual arrangements with a China-based VIE (and not a Chinese operating company) that involve unique risks to investors, including enforcing these contractual agreements due to legal uncertainties and jurisdictional limits, such as:
 - ▶ Chinese law prohibits direct foreign investment in (equity ownership of) the operating companies.
 - ▶ Recent statements and regulatory actions by China's government, such as those related to the use of VIEs, data security and anti-monopoly concerns, may affect the company's ability to conduct its business, accept foreign investments, or list on a US or other foreign exchange.

¹¹⁵ Statement on investor protection related to recent developments in China by SEC Chair Gary Gensler, issued on 30 July 2021, <https://www.sec.gov/news/public-statement/gensler-2021-07-30>.

¹¹⁶ Sample letter to China-based companies issued by SEC Division of Corporation Finance, modified on 20 December 2021, <https://www.sec.gov/corpfin/sample-letter-china-based-companies>.

- ▶ The registrant or the VIE must obtain permission or approvals from Chinese authorities to operate its business (e.g., permissions from the China Securities Regulatory Commission, Cyberspace Administration of China or any other governmental agency).
- ▶ The government of China may decide that the contractual arrangements that are part of the VIE structure do not comply with its regulations, or its regulations could change or be interpreted differently in the future.
- ▶ The Chinese government may intervene or influence the operations at any time, which could result in a material change in operations.
- ▶ The contracts and arrangements through which the registrant has economic rights and exercises control over the VIEs, which results in consolidation of the VIEs, including a clear description of the conditions that the registrant and the WFOEs have satisfied for consolidation of the VIEs, including that it is the primary beneficiary of the VIEs.
- ▶ The transfer, dividend or distribution of cash between the holding company, its subsidiaries and consolidated VIEs, or to investors, including amounts where applicable, or that there were none to date, including:
 - ▶ The restrictions on foreign exchange and ability to transfer cash between entities, across borders, and to US investors
 - ▶ Any restrictions or limits on the ability to distribute earnings from the company, or the VIEs, to the parent and US investors, as well as the ability to settle amounts owed under the VIE agreements
- ▶ A condensed consolidating schedule that disaggregates the operations and depicts the financial position, cash flows and results of operations as of the same dates and for the same periods for which audited consolidated financial statements are required. The schedule should:
 - ▶ Present major line items, such as revenue and cost of goods or services, and subtotals and disaggregated intercompany amounts, such as separate line items for intercompany receivables and investment in subsidiary
 - ▶ Disaggregate the parent company, the VIEs and its consolidated subsidiaries, the WFOEs that are the primary beneficiary of the VIEs, and an aggregation of other entities that are consolidated
 - ▶ Present any intercompany amounts on a gross basis and, when necessary, more disclosure should be included to prevent the information from being misleading

Registrants also should determine whether additional disclosures are required by other GAAP (e.g., ASC 275, ASC 440, ASC 450).

23.3 Other procedures and disclosure requirements related to consolidation

Excerpt from Accounting Standards Codification

Consolidation – Overall

Disclosure

Consolidation Policy

810-10-50-1

Consolidated financial statements shall disclose the consolidation policy that is being followed. In most cases this can be made apparent by the headings or other information in the financial statements, but in other cases a note to financial statements is required.

Parent with a Less-than-Wholly-Owned Subsidiary

810-10-50-1A

A **parent** with one or more less-than-wholly-owned **subsidiaries** shall disclose all of the following for each reporting period:

- a. Separately, on the face of the consolidated financial statements, both of the following:
 1. The amounts of consolidated net income and consolidated comprehensive income
 2. The related amounts of each attributable to the parent and the **noncontrolling interest**.
- b. Either in the notes or on the face of the consolidated income statement, amounts attributable to the parent for any of the following, if reported in the consolidated financial statements:
 1. Income from continuing operations
 2. Discontinued operations
 3. Subparagraph superseded by Accounting Standards Update No. 2015-01.
- c. Either in the consolidated statement of changes in equity, if presented, or in the notes to consolidated financial statements, a reconciliation at the beginning and the end of the period of the carrying amount of total equity (net assets), equity (net assets) attributable to the parent, and equity (net assets) attributable to the noncontrolling interest. That reconciliation shall separately disclose all of the following:
 1. Net income
 2. Transactions with owners acting in their capacity as owners, showing separately contributions from and distributions to owners
 3. Each component of other comprehensive income.
- d. In notes to the consolidated financial statements, a separate schedule that shows the effects of any changes in a parent's ownership interest in a subsidiary on the equity attributable to the parent.

Example 2 (see paragraph 810-10-55-4G) illustrates the application of the guidance in this paragraph.

A reporting entity must disclose the consolidation policy that is being followed. This may be apparent in the headings or other information in the financial statements. In other cases, a note to financial statements is required.

We have observed that the SEC staff has asked public companies to enhance their disclosures by stating how allocations among controlling and noncontrolling interests are made. Therefore, we believe it is appropriate to disclose the terms and effects of any material substantive profit-sharing arrangements (i.e., when profits and losses are allocated in amounts that differ from the stated ownership of the subsidiary). See section 16.1.1 for more guidance on identifying these arrangements.

The disclosure requirements in the general sections of ASC 810, including both those described above as well as the remainder of section 23.3, apply to both voting interest entities and VIEs.

See our publications, *SEC annual reports – Form 10-K*, and *SEC quarterly reports – Form 10-Q*, for guidance on financial statement requirements in periodic SEC filings.

23.3.1 Consolidated statements of net income and comprehensive income presentation

ASC 810 and Rule 5-03 of Regulation S-X require that consolidated net income and consolidated comprehensive income include the revenues, expenses, gains and losses from both the parent and the noncontrolling interest. The FASB believes that consolidated financial statements are more relevant if the user is able to distinguish between amounts attributable to both the owners of the parent company and the noncontrolling interest.¹¹⁷ For the user to make that determination, the amounts of consolidated net income and consolidated comprehensive income attributable to both the parent and the noncontrolling interest should be presented on the face of the financial statements. In addition, the amounts attributable to the parent for income from continuing operations and discontinued operations should be disclosed either on the face of the income statement or in the notes to the consolidated financial statements. See Illustration 23-3 for an example of a consolidated statement of income and statement of consolidated statement of comprehensive income.

The requirement to attribute comprehensive income between the controlling and noncontrolling interest implicitly requires the attribution of other comprehensive income, including reclassifications out of accumulated other comprehensive income. See section 4.4.4 of our FRD, *Foreign currency matters*, for guidance on the attribution of cumulative translation adjustments to noncontrolling interests and see section C7.1.4, *Reporting other comprehensive income*, and section C7.1.7.2, *Reporting reclassification adjustments out of AOCI – noncontrolling interests*, of our Accounting Manual for guidance on those topics.

Earnings per share is calculated based on consolidated net income attributable to the parent. Redeemable securities can affect the calculation of income available to common stockholders. See section 3.2 and 7.1.1 of our FRD, *Earnings per share*, for additional discussion of how consolidated net income attributable to the noncontrolling interest is treated in the calculation of earnings per share and the presentation of net income attributable to the parent, and the interaction of the guidance on discontinued operations and noncontrolling interests in the calculation of earnings per share.

23.3.2 Reconciliation of equity presentation

ASC 810 also requires a reconciliation of the carrying amount of total equity from the beginning of the period to the end of the period. This reconciliation includes total equity, equity attributable to the parent and equity attributable to the noncontrolling interest. The reconciliation should separately disclose net income, transactions with owners acting in their capacity as owners (showing separately contributions from and distributions to owners) and each component of other comprehensive income.

For SEC registrants, this requirement is satisfied by including equity attributable to the noncontrolling interest in the statement of changes in equity. Entities not registered with the SEC are not required to include a statement of changes in equity. Therefore, the disclosure requirements related to this reconciliation can be satisfied by including a statement of changes in equity or including the required information in the notes to the consolidated financial statements. In addition to the reconciliation of the carrying amount of equity, the effect of any changes in the parent's ownership interest in a subsidiary on equity attributable to the parent should be disclosed in the notes to the consolidated financial statements. See Illustration 23-3 for an example of a consolidated statement of changes in equity. See section C7.1.6, *Presentation of AOCI*, of our Accounting Manual for additional guidance on presenting AOCI.

¹¹⁷ Paragraph B64 of FAS 160.

If material, Rule 5-02(31) of Regulation S-X (codified in ASC 210-10-S99-1) requires registrants to present noncontrolling interest amounts represented by preferred stock and applicable dividend requirements separately in a note.

23.3.2.1 Presentation of redeemable noncontrolling interests in the equity reconciliation

ASC 810-10-50-1A(c) and Rule 3-04 of Regulation S-X (codified in ASC 505-10-S99-1) require registrants to reconcile total equity at the beginning of the period to total equity at the end of the period. ASC 480-10-S99-3A specifies that securities that are redeemable at the option of the holder or outside the control of the issuer, including redeemable noncontrolling interests, are to be presented outside permanent equity (in the mezzanine section of the statement of financial position) and prohibits such instruments from being included in any caption titled “total equity.” Therefore, registrants with redeemable noncontrolling interests should not include these items in any caption titled “total equity” in the reconciliation of the carrying amount of equity required under ASC 810-10-50-1A(c).

The SEC staff¹¹⁸ has identified two potentially acceptable means of presentation to satisfy the requirements of both ASC 480-10-S99-3A and ASC 810-10-50-1A(c):

- ▶ Provide a column for redeemable noncontrolling interests in the equity reconciliation but exclude the related amounts from any “total” column. For example, this column could be presented separately to the right of the column reconciling total equity. In that case, the reconciliation could include a row for net income or a supplemental table identifying the allocation of net income among controlling interests, noncontrolling interests and redeemable noncontrolling interests.
- ▶ Exclude redeemable noncontrolling interests from the equity reconciliation but provide a supplemental table, reconciling the beginning and ending balance of redeemable noncontrolling interests. The supplemental table may be in either the notes to the financial statements or the “statement of changes in equity and noncontrolling interests.” In this case, the caption “net income” in the equity reconciliation could note parenthetically the amount related to redeemable noncontrolling interests.

Other means of presenting the reconciliation of total equity may be acceptable. The SEC would evaluate the appropriateness of other presentations based on the specific facts and circumstances. See section 5.10 of our FRD, *Issuer’s accounting for debt and equity financings*, for further interpretive guidance and section 15.2 of this FRD for guidance on redeemable noncontrolling interests.

23.3.2.2 Interim reporting period requirements

As discussed above, ASC 810-10-50-1A(c) requires that a parent with one or more less-than-wholly-owned subsidiaries must disclose equity reconciliations for each reporting period, which includes interim reporting periods. However, ASC 810 does not specify whether the reconciliation must be disclosed for each quarter or on a year-to-date basis, or both.

The interim financial statement requirements in Rules 10-01(a)(7) and 8-03(a)(5) of Regulation S-X require registrants to include reconciliations of shareholders’ equity either in the statements or in the notes to the statements. All domestic SEC registrants are required to disclose reconciliations of the beginning balance to the ending balance of each caption in stockholders’ equity for each period for which an income statement is required to be filed and comply with the remaining content requirements of Rule 3-04 of Regulation S-X. As a result, registrants are required to provide the reconciliation for both the year-to-date and quarterly periods and comparable periods in Form 10-Q but only for the year-to-date periods in registration statements.

¹¹⁸ The SEC staff’s views described here are included in the publicly available minutes of the Center for Audit Quality’s 23 June 2009 SEC Regulations Committee meeting.

The SEC's rules do not prescribe the format of the presentation, as long as the appropriate periods are provided. Examples of presentations that would be acceptable include:

- ▶ A single statement/presentation that reconciles the components and total of shareholders' equity from the prior year-end to the balances/subtotals at the end of the first quarter and continuing the reconciliation to the balances/subtotals at the end of each succeeding quarter with comparative reconciliations for the prior year periods
- ▶ One statement/presentation that reconciles those components and the total for both the year-to-date period and comparable prior-year period and a second statement/presentation that reconciles the beginning and ending balances/subtotals for both the quarterly period and comparable period

Non-SEC registrants may follow the SEC requirements. Alternatively, we believe a non-SEC registrant may present the reconciliation or disclosure only on a year-to-date basis, consistent with the presentation requirements for the statement of cash flows, which provides information about the activity of balance sheet amounts (i.e., cash and cash equivalents) between periods.

Section C7.1.9, *Interim period reporting*, of our Accounting Manual provides additional guidance and examples when there is no noncontrolling interest.

23.3.3

Consolidated statement of financial position presentation

Although ASC 810 does not explicitly require that a subtotal for "total parent shareholders' equity" be presented on the face of the statement of financial position, we believe that an entity should present this subtotal based on the example in ASC 810-10-55-4I. ASC 810-10-50-1A(c) requires that an entity disclose a reconciliation at the beginning and the end of the period of the carrying amount of equity attributable to the parent, either in the consolidated statement of changes in equity, if presented, or in the notes to the consolidated financial statements. The illustrative example in ASC 810-10-55-4I presents a subtotal for the total parent shareholders' equity. Therefore, we believe that an entity should present a subtotal for the total parent shareholders' equity on the face of the statement of financial position separately from noncontrolling interest and before arriving at total equity. See Illustration 23-3 for an example of a consolidated statement of financial position.

Question 23.4

How should an insurer consolidate a controlled investment fund if a portion of the consolidated investment fund is owned by the insurer's separate accounts?

In accordance with ASC 944-80-25-12, the insurer should consolidate the investment fund in the following manner:

- ▶ The portion of the fund assets representing the contract holder's interests should be included as separate account assets and liabilities in accordance with ASC 944-80-25-3.
- ▶ The remaining portion of the fund assets (including the portion owned by any other investors) should be included in the general account of the insurer on a line-by-line basis.
- ▶ Noncontrolling interests should not be included in the separate account liability but rather classified as a liability or equity based on other applicable guidance.

As discussed in section 10.3.4, under ASC 944-80-25-3,¹¹⁹ when evaluating an entity for consolidation, an insurer should not consider any separate account interests held for the benefit of policy holders to be the insurer's interests nor should it combine any separate account interests held for the benefit of policy holders with the insurer's general account interest in the same investment. See Appendix G for additional consolidation considerations related to these funds.

¹¹⁹ The guidance applies if the separate account meets the conditions in ASC 944-80-25-2.

23.3.4 Consolidated statement of cash flows presentation

ASC 810 does not prescribe the presentation for the statement of cash flows. Therefore, entities with noncontrolling interests should look to ASC 230 for guidance. ASC 230 requires entities to provide a reconciliation of net income to net cash flows from operating activities regardless of whether the direct or indirect method is used for presenting net cash flows from operating activities. Therefore, entities should start with net income in their statement of cash flows presentation when applying the indirect method rather than net income attributable to the parent. Illustration 23-2 provides an example of this presentation.

Illustration 23-2: Preparing the statement of cash flows under the indirect method

The net income of Company A was as follows for the years ended 31 December 20X9 and 20X8:

- ▶ Net income was \$1,200 and \$1,000, respectively
- ▶ Net income attributable to the noncontrolling interests was \$240 and \$200, respectively
- ▶ Net income attributable to the Parent was \$960 and \$800, respectively

Analysis

In preparing the statement of cash flows under the indirect method, Company A would begin with net income, including income attributable to the noncontrolling interests. Therefore, Company A would begin with net income amounts of \$1,200 and \$1,000 for the years ended 31 December 20X9 and 20X8, respectively.

See section 5.10.5 of our FRD, *Statement of cash flows*, for further discussion of considerations related to statement of cash flow presentation for transactions with noncontrolling interest holders while control is maintained.

23.3.4.1 Presentation of transaction costs in the statement of cash flows

As described in section 18.4.4, companies will have to make a policy election concerning whether to reflect transaction costs associated with purchases and sales of noncontrolling interests that are in the scope of ASC 810 as an expense in the consolidated statement of income or as a direct charge to equity. We believe the most appropriate classification of transaction costs in the consolidated statement of cash flows would be consistent with that accounting. Accordingly, if transaction costs are reflected as an expense, we believe the related cash flows would be most appropriately reflected as an operating activity. Alternatively, if the transaction costs are reflected as a direct charge to equity, we believe the related cash flows would be most appropriately classified as a financing activity.

23.3.5 Disclosures for deconsolidation of a subsidiary in the scope of ASC 810

Excerpt from Accounting Standards Codification

Consolidation – Overall

Disclosure

810-10-50-1B

In the period that either a subsidiary is deconsolidated or a group of assets is derecognized in accordance with paragraph 810-10-40-3A, the parent shall disclose all of the following:

- a. The amount of any gain or loss recognized in accordance with paragraph 810-10-40-5
- b. The portion of any gain or loss related to the remeasurement of any retained investment in the former subsidiary or group of assets to its fair value

- c. The caption in the income statement in which the gain or loss is recognized unless separately presented on the face of the income statement
- d. A description of the valuation technique(s) used to measure the fair value of any direct or indirect retained investment in the former subsidiary or group of assets
- e. Information that enables users of the parent's financial statements to assess the inputs used to develop the fair value in item (d)
- f. The nature of continuing involvement with the subsidiary or entity acquiring the group of assets after it has been deconsolidated or derecognized
- g. Whether the transaction that resulted in the deconsolidation or derecognition was with a related party
- h. Whether the former subsidiary or entity acquiring a group of assets will be a related party after deconsolidation.

ASC 810 requires disclosure of any gain or loss recognized on the deconsolidation of a subsidiary that is a business or derecognition of a group of assets, including a VIE. The amount and classification of the gain or loss in the income statement are disclosed in the notes to the consolidated financial statements along with the amount of the gain or loss related to the remeasurement of any retained interest in the deconsolidated subsidiary or group of assets (see section 19.3.2).

ASC 810 requires disclosure of a description of the valuation technique(s) used to measure the fair value of any direct or indirect retained investment in a deconsolidated subsidiary or group of assets (e.g., a discounted cash flow approach). Disclosure of the information that enables users of the parent's financial statements to assess the inputs used to develop the fair value measurements for the retained interest in the former subsidiary or group of assets is also required. For example, for a discounted cash flow approach, disclosures may include information on discount rates and the assumed capital structure, capitalization rates for terminal cash flows, assumptions about expected growth in revenues, expected profit margins, expected capital expenditures, expected depreciation and amortization, expected working capital requirements, discounts for lack of marketability or lack of control and other assumptions that may have a significant effect on the valuation.

For a market approach, disclosures may include information on the valuation multiples used in the analysis, a description of the population of the guideline companies or similar transactions from which the multiples were derived, the timeliness of the market data used, the method by which the multiples were selected (e.g., use of the median, use of an average, the financial performance of the subject company compared to the relative performance of the guideline companies) and discounts for lack of marketability and lack of control. An entity also is required to disclose the valuation techniques used to measure an equity interest in an acquiree held by the entity immediately before the acquisition date in a business combination achieved in stages.

An entity also must disclose the nature of its continuing involvement with the deconsolidated subsidiary or the entity acquiring the group of assets and whether a related party relationship exists. This disclosure is intended to highlight circumstances in which a gain or loss is recognized but the continuing relationship may affect the ultimate amounts realized from the sale and resulting relationship.

See section 3.1 of our publication, *Pro forma financial information – A guide for applying amended Article 11 of Regulation S-X*, for guidance on Item 2.01 of Form 8-K, which requires a registrant to disclose information about a disposal of significant assets.

23.3.6 Disclosures required upon a change in the entities consolidated

Excerpt from Accounting Standards Codification

Consolidation – Overall

SEC Materials

810-10-S99-3 (Regulation S-X Rule 3A-03, Statement as to Principles of Consolidation or Combination Followed)

The following is the text of Regulation S-X Rule 3A-03, Statement as to Principles of Consolidation or Combination Followed (17 CFR 210.3A-03) ...

- (b) As to each consolidated financial statement and as to each combined financial statement, if there has been a change in the persons included or excluded in the corresponding statement for the preceding fiscal period filed with the Commission that has a material effect on the financial statements, the persons included and the persons excluded shall be disclosed.

When the entities included in the consolidated or combined financial statements or excluded from those financial statements change from the preceding period (e.g., due to an acquisition or disposal, respectively), and that change has a material effect on the financial statements, registrants are required to disclose that fact. Other disclosures also may be required if other guidance applies to the transaction, for example:

- ▶ See sections 8.4 or A.5 of our FRD, ***Business combinations***, for disclosure requirements for transactions in the scope of that standard.
- ▶ See section 23.2 for disclosure requirements related to the initial consolidation of a VIE.
- ▶ See our FRD, ***Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)***, for disclosure requirements for transactions in the scope of that standard.
- ▶ See our FRD, ***Discontinued operations: Accounting Standards Codification 205-20***.

23.4

Example of presentation and disclosures under ASC 810

Illustration 23-3: Presentation and disclosure example

The following financial statements and selected notes for Company P illustrate the presentation and disclosure requirements in ASC 810. The quantitative disclosures required by ASC 810-10-50-1A(c) reflected in the consolidated statement of changes in equity in this example may instead be reflected in the notes to the consolidated financial statements. This example does not include the qualitative disclosure requirements of ASC 810-10-50-1B(d) through 1B(h).

Company P		
Consolidated Statement of Financial Position		
(all amounts in dollars)		
	31 December,	
	20X3	20X2
Assets:		
Cash	83,700	39,600
Marketable securities	17,500	15,500
Inventory	30,000	30,000
Buildings and equipment, net	59,850	68,400
Goodwill	4,286	4,286
Total assets	195,336	157,786
Liabilities:		
Accounts payable	75,000	75,000
Debt	27,000	27,000
Total liabilities	102,000	102,000
Equity:		
Company P shareholders' equity:		
Common stock	1,500	1,500
Additional paid-in capital	15,440	5,747
Accumulated other comprehensive income	3,300	3,150
Retained earnings	57,240	40,770
Total Company P shareholders' equity	77,480	51,167
Noncontrolling interest	15,856	4,619
Total equity	93,336	55,786
Total liabilities and equity	195,336	157,786

In the consolidated statement of financial position, Company P separately identifies Company P's shareholders' equity and the noncontrolling interest.

Company P			
Consolidated Statement of Income			
(all amounts in dollars, except share amounts)			
	Year Ended 31 December,		
	20X3	20X2	20X1
Revenues	96,000	96,000	96,000
Cost of revenues	42,000	42,000	46,500
Gross profit	54,000	54,000	49,500
Selling and administrative	26,550	26,550	26,550
Consolidated net income	27,450	27,450	22,950
Less: Net income attributable to noncontrolling interest	10,980	2,745	6,885
Net income attributable to Company P	16,470	24,705	16,065
Earnings per share – basic and diluted:			
Net income attributable to Company P common shareholders	10.98	16.47	10.71
Weighted average shares outstanding	1,500	1,500	1,500

Company P			
Consolidated Statement of Comprehensive income			
(all amounts of dollars)			
	Year Ended 31 December,		
	20X3	20X2	20X1
Net income	27,450	27,450	22,950
Other comprehensive income and reclassification adjustments:			
Foreign currency translation adjustment	2,000	(1,500)	5,000
Total other comprehensive income and reclassification adjustments	2,000	(1,500)	5,000
Comprehensive income	29,450	25,950	27,950
Less: Comprehensive income attributable to noncontrolling interest	11,780	2,595	8,385
Comprehensive income attributable to Company P	17,670	23,355	19,565

Consolidated net income is attributed to the controlling and noncontrolling interests.

Company P						
Consolidated Statement of Changes in Equity						
	Company P shareholders					
	Retained earnings	Accumulated other comprehensive income	Common stock	Additional paid-in capital	Non-controlling interest	Total
1 January 20X1	-	-	-	-	-	-
Issuance of common stock	-	-	1,500	34,500	-	36,000
Purchase of Company S	-	-	-	-	19,286	19,286
Dividends paid to noncontrolling interest on subsidiary common stock	-	-	-	-	(10,800)	(10,800)
Comprehensive income:						
Net income	16,065	-	-	-	6,885	22,950
Other comprehensive income:						
Foreign currency translation adjustment	-	3,500	-	-	1,500	5,000
Other comprehensive income	-	3,500	-	-	1,500	5,000
Comprehensive income	16,065	3,500	-	-	8,385	27,950
Dividends paid on common stock	-	-	-	-	-	-
31 December 20X1	16,065	3,500	1,500	34,500	16,871	72,436

The consolidated statement of changes in equity includes an additional column representing the changes in noncontrolling interest.

Company P						
Consolidated Statement of Changes in Equity						
Company P shareholders						
	Retained earnings	Accumulated other comprehensive income	Common stock	Additional paid-in capital	Non-controlling interest	Total
1 January 20X2	16,065	3,500	1,500	34,500	16,871	72,436
Purchase of subsidiary shares from noncontrolling interest	-	1,000	-	(28,753)	(11,247)	(39,000)
Dividends paid to noncontrolling interest on subsidiary common stock	-	-	-	-	(3,600)	(3,600)
Comprehensive income:						
Net income	24,705	-	-	-	2,745	27,450
Other comprehensive income:						
Foreign currency translation adjustment	-	(1,350)	-	-	(150)	(1,500)
Other comprehensive income	-	(1,350)	-	-	(150)	(1,500)
Comprehensive income	24,705	(1,350)	-	-	2,595	25,950
Dividends paid on common stock	-	-	-	-	-	-
31 December 20X2	40,770	3,150	1,500	5,747	4,619	55,786

The consolidated statement of changes in equity includes an additional column representing the changes in noncontrolling interest.

Company P						
Consolidated Statement of Changes in Equity						
Company P shareholders						
	Retained earnings	Accumulated other comprehensive income	Common stock	Additional paid-in capital	Non-controlling interest	Total
1 January 20X3	40,770	3,150	1,500	5,747	4,619	55,786
Sales of subsidiary shares to noncontrolling interest	-	(1,050)	-	9,693	13,857	22,500
Dividends paid to noncontrolling interest on subsidiary common stock	-	-	-	-	(14,400)	(14,400)
Comprehensive income:						
Net income	16,470	-	-	-	10,980	27,450
Other comprehensive income:						
Foreign currency translation adjustment	-	1,200	-	-	800	2,000
Other comprehensive income	-	1,200	-	-	800	2,000
Comprehensive income	16,470	1,200	-	-	11,780	29,450
Dividends paid on common stock	-	-	-	-	-	-
31 December 20X3	57,240	3,300	1,500	15,440	15,856	93,336

The consolidated statement of changes in equity includes an additional column representing the changes in noncontrolling interest.

Company P			
Notes to Consolidated Financial Statements			
Years Ended 31 December, 20X3, 20X2, 20X1			
(all amounts in dollars)			
Net Income Attributable to Company P and Transfers (to) from the Noncontrolling Interest			
	20X3	20X2	20X1
Net income attributable to Company P	16,470	24,705	16,065
Transfers (to) from the noncontrolling interest			
Increase in Company P's paid-in capital for sale of 9,000 Company S common shares	9,693	-	-
Decrease in Company P's paid-in capital for purchase of 6,000 Company S common shares	-	(28,753)	-
Net transfers (to) from noncontrolling interest	9,693	(28,753)	-
Change from net income attributable to Company P and transfers (to) from noncontrolling interest	26,163	(4,048)	16,065

Company P also discloses the effects of changes in Company P's ownership interest in its subsidiary on Company P's equity. This schedule would be presented as a note in the company's financial statements.

A Abbreviations used in this publication

Abbreviation	FASB Accounting Standards Codification
ASC 205	FASB ASC Topic 205, <i>Presentation of Financial Statements</i>
ASC 210	FASB ASC Topic 210, <i>Balance Sheet</i>
ASC 220	FASB ASC Topic 220, <i>Comprehensive Income</i>
ASC 230	FASB ASC Topic 230, <i>Statement of Cash Flows</i>
ASC 250	FASB ASC Topic 250, <i>Accounting Changes and Error Corrections</i>
ASC 272	FASB ASC Topic 272, <i>Limited Liability Entities</i>
ASC 275	FASB ASC Topic 275, <i>Risks and Uncertainties</i>
ASC 310	FASB ASC Topic 310, <i>Receivables</i>
ASC 320	FASB ASC Topic 320, <i>Investments – Debt Securities</i>
ASC 321	FASB ASC Topic 321, <i>Investments – Equity Securities</i>
ASC 323	FASB ASC Topic 323, <i>Investments – Equity Method and Joint Ventures</i>
ASC 325	FASB ASC Topic 325, <i>Investments – Other</i>
ASC 350	FASB ASC Topic 350, <i>Intangibles – Goodwill and Other</i>
ASC 360	FASB ASC Topic 360, <i>Property, Plant, and Equipment</i>
ASC 440	FASB ASC Topic 440, <i>Commitments</i>
ASC 450	FASB ASC Topic 450, <i>Contingencies</i>
ASC 460	FASB ASC Topic 460, <i>Guarantees</i>
ASC 470	FASB ASC Topic 470, <i>Debt</i>
ASC 480	FASB ASC Topic 480, <i>Distinguishing Liabilities from Equity</i>
ASC 505	FASB ASC Topic 505, <i>Equity</i>
ASC 605	FASB ASC Topic 605, <i>Revenue Recognition</i>
ASC 606	FASB ASC Topic 606, <i>Revenue from Contracts with Customers</i>
ASC 610	FASB ASC Topic 610, <i>Other Income</i>
ASC 710	FASB ASC Topic 710, <i>Compensation – General</i>
ASC 712	FASB ASC Topic 712, <i>Compensation – Nonretirement Postemployment Benefits</i>
ASC 715	FASB ASC Topic 715, <i>Compensation – Retirement Benefits</i>
ASC 718	FASB ASC Topic 718, <i>Compensation – Stock Compensation</i>
ASC 730	FASB ASC Topic 730, <i>Research and Development</i>
ASC 740	FASB ASC Topic 740, <i>Income Taxes</i>
ASC 805	FASB ASC Topic 805, <i>Business Combinations</i>
ASC 808	FASB ASC Topic 808, <i>Collaborative Arrangements</i>
ASC 810	FASB ASC Topic 810, <i>Consolidation</i>
ASC 815	FASB ASC Topic 815, <i>Derivatives and Hedging</i>
ASC 820	FASB ASC Topic 820, <i>Fair Value Measurement</i>
ASC 825	FASB ASC Topic 825, <i>Financial Instruments</i>
ASC 830	FASB ASC Topic 830, <i>Foreign Currency Matters</i>
ASC 835	FASB ASC Topic 835, <i>Interest</i>
ASC 840	FASB ASC Topic 840, <i>Leases</i>
ASC 842	FASB ASC Topic 842, <i>Leases</i>
ASC 845	FASB ASC Topic 845, <i>Nonmonetary Transactions</i>

Abbreviation	<i>FASB Accounting Standards Codification</i>
ASC 848	FASB ASC Topic 848, <i>Reference Rate Reform</i>
ASC 850	FASB ASC Topic 850, <i>Related Party Disclosures</i>
ASC 860	FASB ASC Topic 860, <i>Transfers and Servicing</i>
ASC 910	FASB ASC Topic 910, <i>Contractors – Construction</i>
ASC 932	FASB ASC Topic 932, <i>Extractive Activities – Oil and Gas</i>
ASC 940	FASB ASC Topic 940, <i>Financial Services – Brokers and Dealers</i>
ASC 944	FASB ASC Topic 944, <i>Financial Services – Insurance</i>
ASC 946	FASB ASC Topic 946, <i>Financial Services – Investment Companies</i>
ASC 952	FASB ASC Topic 952, <i>Franchisors</i>
ASC 958	FASB ASC Topic 958, <i>Not-for-Profit Entities</i>
ASC 960	FASB ASC Topic 960, <i>Plan Accounting – Defined Benefit Pension Plans</i>
ASC 962	FASB ASC Topic 962, <i>Plan Accounting – Defined Contribution Pension Plans</i>
ASC 965	FASB ASC Topic 965, <i>Plan Accounting – Health and Welfare Benefit Plans</i>
ASC 970	FASB ASC Topic 970, <i>Real Estate – General</i>
ASC 980	FASB ASC Topic 980, <i>Regulated Operations</i>
Abbreviation	<i>Other authoritative standards</i>
ASR 268	SEC Accounting Series Release No. 268, <i>Presentation in Financial Statements of Redeemable Preferred Stock</i>
GASB 20	Governmental Accounting Standards Board Statement No. 20, <i>Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting</i>
GASB 34	Governmental Accounting Standards Board Statement No. 34, <i>Basic Financial Statements – And Management’s Discussion and Analysis – For State and Local Governments</i>
ASU 2009-17	Accounting Standards Update No. 2009-17, <i>Consolidation (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities</i>
ASU 2014-01	Accounting Standards Update No. 2014-01, <i>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)</i>
ASU 2014-07	Accounting Standards Update No. 2014-07, <i>Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, a consensus of the Private Company Council</i>
ASU 2014-13	Accounting Standards Update No. 2014-13, <i>Consolidation (Topic 810): Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity</i>
ASU 2015-02	Accounting Standards Update No. 2015-02, <i>Consolidation (Topic 810): Amendments to the Consolidation Analysis</i>
ASU 2017-05	Accounting Standards Update No. 2017-05, <i>Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets</i>
ASU 2018-17	Accounting Standards Update No. 2018-17, <i>Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities</i>
ASU 2023-02	Accounting Standards Update No. 2023-02, <i>Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method (a consensus of the Emerging Issues Task Force)</i>

Abbreviation	<i>Non-authoritative standards</i>
CON 6	FASB Statement of Financial Accounting Concepts No. 6, <i>Elements of Financial Statements – a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)</i>
CON 7	FASB Statement of Financial Accounting Concepts No. 7, <i>Using Cash Flow Information and Present Value in Accounting Measurements</i>
Custody Rule	Rule 206(4)-2(b)(4) under the Investment Advisers Act of 1940 (the Custody Rule)
EITF 98-2	EITF Issue No. 98-2, <i>Accounting by a Subsidiary or Joint Venture for an Investment in the Stock of Its Parent Company or Joint Venture Partner</i>
EITF 02-5	EITF Issue No. 02-5, <i>Definition of “Common Control” in Relation to FASB Statement No. 141</i>
EITF 09-4	EITF Issue No. 09-4, <i>Seller Accounting for Contingent Consideration</i>
EITF 00-1	EITF Issue No. 00-1, <i>Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures</i>
FIN 46	FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities – an interpretation of ARB No. 51</i>
FIN 46(R)	FASB Interpretation No. 46 (Revised), <i>Consolidation of Variable Interest Entities – an interpretation of ARB No. 51</i>
FSP FIN 46(R)-5	FASB Staff Position FIN 46(R)-5, <i>Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)</i>
FSP FIN 46(R)-3	FASB Staff Position FIN 46(R)-3, <i>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</i>
Issue E22	Statement 133 Implementation Issue No. E22, <i>Accounting for the Discontinuance of Hedging Relationships Arising from Changes in Consolidation Practices Related to Applying FASB Interpretation No. 46 or 46(R)</i>
FAS 133	Statement of Financial Accounting Standards No. 133, <i>Accounting for Derivative Instruments and Hedging Activities</i>
FAS 141	Statement of Financial Accounting Standards No. 141, <i>Business Combinations</i>
FAS 141(R)	Statement of Financial Accounting Standards No. 141(R), <i>Business Combinations</i>
FAS 160	Statement of Financial Accounting Standards No. 160, <i>Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB NO. 51</i>
FAS 167	Statement of Financial Accounting Standards No. 167, <i>Amendments to FASB Interpretation No. 46(R)</i>
Rule 1-02	Regulation S-X: Form and content of and requirements for financial statements, <i>Definition of terms used in Regulation S-X (17 CFR Part 210)</i>
Rule 2a-7	Investment Company Act of 1940, <i>Money market funds</i>
Rule 3-04	Regulation S-X: Form and content of and requirements for financial statements, <i>Changes in stockholders’ equity and noncontrolling interests</i>
Rule 3-05	Regulation S-X: Form and content of and requirements for financial statements, <i>Financial statements of businesses acquired or to be acquired</i>
Rule 3-10	Regulation S-X: Form and content of and requirements for financial statements, <i>Financial statements of guarantors and issuers of guaranteed securities registered or being registered</i>
Rule 3-14	Regulation S-X: Form and content of and requirements for financial statements, <i>Special instructions for real estate operations to be acquired</i>
Rule 3A-02	Regulation S-X: Form and content of and requirements for financial statements, <i>Consolidated statements of income and cash flows</i>

Abbreviation	<i>Non-authoritative standards</i>
Rule 3A-03	Regulation S-X: Form and content of and requirements for financial statements, <i>Statement as to principles of consolidation or combination followed</i>
Rule 5-02	Regulation S-X: Form and content of and requirements for financial statements, <i>Balance sheets</i>
Rule 5-03	Regulation S-X: Form and content of and requirements for financial statements, <i>Statements of comprehensive income</i>
Rule 6-03	Regulation S-X: Form and content of and requirements for financial statements, <i>Special rules of general application to registered investment companies and business development companies</i>
Rule 8-03	Regulation S-X: Form and content of and requirements for financial statements, <i>Interim financial statements</i>
Rule 10-01	Regulation S-X: Form and content of and requirements for financial statements, <i>Interim financial statements</i>
Rule 12-04	Regulation S-X: Form and content of and requirements for financial statements, <i>Condensed financial information of registrant</i>
SAB Topic 1.B.1	SEC Staff Accounting Bulletin Topic 1.B.1, <i>Costs reflected in historical financial statements</i>
SAB Topic 5.E	SEC Staff Accounting Bulletin Topic 5.E, <i>Accounting for Divestiture of a Subsidiary or Other Business Operations</i>
TQA 1400.29	AICPA Technical Questions and Answers – Consolidated Versus Combined Financial Statements Under FASB ASC 810, <i>Consolidation</i>

B Index of ASC references in this publication

ASC paragraph	Section	
ASC 210-10-S99-1	23.3.2	Reconciliation of equity presentation
ASC 220-10-S99-3	22.2.1	Intercompany and other adjustments
ASC 250	11.2.1.1	Consolidation of a not-for-profit organization
ASC 250-10-45-1 through 16	14.6	Differing accounting policies between parent and subsidiary
ASC 250-10-45-2	14.6	Differing accounting policies between parent and subsidiary
ASC 250-10-45-11	14.6	Differing accounting policies between parent and subsidiary
ASC 272-10-05-2 through 4	7.3.1.6	Limited liability companies
ASC 321-10-30-1	18.3	Scope of guidance in ASC 810 on a change in interest (without loss of control)
ASC 321-10-30-1	19.3	Scope of guidance in ASC 810 on loss of control
ASC 323	22.2.2	Investments in subsidiaries
ASC 323-10-35-6	14.4	Using subsidiary financial statements prepared as of an earlier period end for consolidation procedures in circumstances when the subsidiary has the same fiscal year end as the parent
ASC 323-10-35-35	18.3	Scope of guidance in ASC 810 on a change in interest (without loss of control)
ASC 323-10-35-35	19.3	Scope of guidance in ASC 810 on loss of control
ASC 323-30-15-3	4.4.4.1.1	Determining whether an entity is a joint venture
ASC 323-740-05-2 through 3	F.1	Summary of the tax credit
ASC 323-740-25-1	9.2	Single decision maker
ASC 323-740-25-1	F.1	Primary beneficiary considerations
ASC 350-20-35-57A through B	16.1.4	Attribution of goodwill impairment
ASC 360-10-45-5	19.4.7	Classification and presentation of a gain or loss upon loss of control
ASC 450-20-25-2	19.4.2.1	Accounting for contingent consideration upon a loss of control
ASC 450-30-25-1	19.4.2.1	Accounting for contingent consideration upon a loss of control
ASC 480-10-S99-3A	18.4	Accounting for changes in a parent's ownership interest in a subsidiary in a transaction within the scope of ASC 810
ASC 480-10-S99-3A	19.4.4	Determine the carrying amount of the noncontrolling interest
ASC 480-10-S99-3A	23.3.2.1	Presentation of redeemable noncontrolling interests in the equity reconciliation

ASC paragraph	Section	
ASC 505-10-S99-1	23.3.2.1	Presentation of redeemable noncontrolling interests in the equity reconciliation
ASC 605-35-15-2 through 15-5	14.2	Undivided interests and proportionate consolidation
ASC 610-20-15-4 through 6	18.3	Scope of guidance in ASC 810 on a change in interest (without loss of control)
ASC 610-20-15-4 through 6	19.3	Scope of guidance in ASC 810 on loss of control
ASC 610-20-15-5 through 8	19.3.2.5	Loss of control – substance addressed by ASC 610-20
ASC 610-20-15-10	18.3	Scope of guidance in ASC 810 on a change in interest (without loss of control)
ASC 610-20-15-10	19.3	Scope of guidance in ASC 810 on loss of control
ASC 710-10-25-9	18.4.1	Contingent consideration in an increase in interest
ASC 710-10-45-1	4.3.1.3	Deferred compensation trusts (e.g., a rabbi trust)
ASC 710-10-45-1	11.1.2	Scope of the Voting Model
ASC 805-30-25-5 through 7	13.4.1	Contingent consideration in an asset acquisition when the entity is a VIE that does not constitute a business
ASC 805-50-15-4	13.4	Primary beneficiary of a VIE that is not a business
ASC 805-50-15-6	2.3	Common control
ASC 805-50-30-5	13.2	Primary beneficiary and VIE are under common control
ASC 805-50-30-5	13.4	Primary beneficiary of a VIE that is not a business
ASC 810-10-05-3	7.3.1.6	Limited liability companies
ASC 810-10-10-1	2.2	Controlling financial interest
ASC 810-10-15-3 through 4	4.1	Introduction
ASC 810-10-15-3	11.1	Introduction
ASC 810-10-15-5 through 6	11.1.2	Scope of the Voting Model
ASC 810-10-15-8 through 8A	2.2	Controlling financial interest
ASC 810-10-15-8 through 9	11.2.1	Voting Model: Consolidation of corporations
ASC 810-10-15-8	11.2.1.1	Consolidation of a not-for-profit organization
ASC 810-10-15-8A	1.2.4	Step 4: Is the entity a VIE?
ASC 810-10-15-8A	7.3.1.3.2	Limited partnerships and similar entities
ASC 810-10-15-8A	11.2.2	Voting Model: Control of limited partnerships and similar entities
ASC 810-10-15-9	4.2.4	Majority-owned entities
ASC 810-10-15-10	11.1.2	Scope of the Voting Model
ASC 810-10-15-10	11.3	Exceptions to consolidation by a reporting entity holding a majority of voting stock or limited partnership interests
ASC 810-10-15-10(a)	11.3.1	Foreign currency exchange restrictions
ASC 810-10-15-10(a)	19.2.2	Deconsolidation through a bankruptcy proceeding or governmentally imposed restrictions
ASC 810-10-15-11	14.3	Differing fiscal year-ends between parent and subsidiary
ASC 810-10-15-12	4.3	Scope exceptions to consolidation guidance
ASC 810-10-15-12(d)	G.2	Consolidation by an investment company
ASC 810-10-15-12(d)	G.3	Consolidation of investment companies
ASC 810-10-15-12(f)	4.3.4	Money market funds
ASC 810-10-15-12(f)	23.2.5	Scope-related VIE disclosures

ASC paragraph	Section	
ASC 810-10-15-13	4.4	Scope exceptions to the Variable Interest Model
ASC 810-10-15-13A through 13B	3	Consideration of substantive terms, transactions and arrangements
ASC 810-10-15-13A through 13B	8.3.2	Evaluating disproportionate power and benefits
ASC 810-10-15-14	1.1.2	Voting Model
ASC 810-10-15-14	7.2	The entity does not have enough equity to finance its activities without additional subordinated financial support
ASC 810-10-15-14	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
ASC 810-10-15-14	7.4	Entity established with non-substantive voting rights
ASC 810-10-15-14(a)	4.3.1.3	Deferred compensation trusts (e.g., a rabbi trust)
ASC 810-10-15-14(a)	5.2.1.2.3	Subordination
ASC 810-10-15-14(a)	5.5	Variable interests in specified assets
ASC 810-10-15-14(a)	7.2.2	Determining whether an equity investment is at risk
ASC 810-10-15-14(a)	7.2.2.3	Amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity
ASC 810-10-15-14(a)	7.2.2.4	Amounts financed for the equity holder directly by the entity or by other parties involved with the entity
ASC 810-10-15-14(a)	7.2.2.5	Other examples of determining equity investments at risk
ASC 810-10-15-14(a)	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
ASC 810-10-15-14(a)	F.2	Summary of the investment
ASC 810-10-15-14(a) through (b)	7.3.1.3.2	Limited partnerships and similar entities
ASC 810-10-15-14(b)	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
ASC 810-10-15-14(b)	7.3.1.3.4	Participating rights
ASC 810-10-15-14(b)	7.3.1.3.1	Corporations and similar entities
ASC 810-10-15-14(b)	7.3.1.4	Effect of decision makers or service providers when evaluating ASC 810-10-15-14(b)(1)
ASC 810-10-15-14(b)	7.3.1.5	Franchise arrangements when evaluating ASC 810-10-15-14(b)(1)
ASC 810-10-15-14(b)	7.3.2	Obligation to absorb an entity's expected losses
ASC 810-10-15-14(b)	7.3.3	Right to receive an entity's expected residual returns
ASC 810-10-15-14(b)	F.2	Summary of the investment
ASC 810-10-15-14(b)(2)	7.3.2.1	Common arrangements that may protect equity investments at risk from absorbing losses
ASC 810-10-15-14(b)(2)	7.3.2.2	Disproportionate sharing of losses
ASC 810-10-15-14(b)(2)	7.3.2.3	Variable interests in specified assets or silos
ASC 810-10-15-14(b)(2)	7.3.2.4	Illustrative examples
ASC 810-10-15-14(b)(2)	7.3.3.2	Variable interests in specified assets or silos

ASC paragraph	Section	
ASC 810-10-15-14(b)(3)	7.3.3	Right to receive an entity's expected residual returns
ASC 810-10-15-14(b)(3)	7.3.3.1	Disproportionate sharing of profits
ASC 810-10-15-14(b)(3)	7.3.3.3	Illustrative examples
ASC 810-10-15-14(c)	7.4.1	Condition 1: Votes are disproportionate to economics
ASC 810-10-15-14(c)	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
ASC 810-10-15-14(c)	8.3.2	Evaluating disproportionate power and benefits
ASC 810-10-15-15	4.2.2	Portions of entities
ASC 810-10-15-17	4.4	Scope exceptions to the Variable Interest Model
ASC 810-10-15-17AC through 17AD	E.2	Scope
ASC 810-10-15-17AD	E.5	Disclosures
ASC 810-10-15-17AD(b) and (c)	E.2	Scope
ASC 810-10-15-17AE	E.3	Evaluating common control
ASC 810-10-15-17AF	E.2	Scope
ASC 810-10-15-17D	13.5.1	Measurement alternative for consolidated collateralized financing entities
ASC 810-10-15-17(d)	4.4.4	Business scope exception
ASC 810-10-25-1	11.2.1	Voting Model: Consolidation of corporations
ASC 810-10-25-1A	11.2.2	Voting Model: Control of limited partnerships and similar entities
ASC 810-10-25-2	11.3.2	Evaluating the effect of noncontrolling rights
ASC 810-10-25-3	11.3.2	Evaluating the effect of noncontrolling rights
ASC 810-10-25-5	7.3.1.3.2	Limited partnerships and similar entities
ASC 810-10-25-5	11.3.2	Evaluating the effect of noncontrolling rights
ASC 810-10-25-5	11.3.3	Timing of assessment of control for a voting interest entity
ASC 810-10-25-6 through 8	11.3.2.1	Participating rights
ASC 810-10-25-7	11.3.2.2	Protective rights
ASC 810-10-25-10	7.3.1.3.5	Protective rights
ASC 810-10-25-10	11.3.2.2	Protective rights
ASC 810-10-25-11 through 12	11.3.2.1	Participating rights
ASC 810-10-25-13	11.3.2.1.1	Evaluating the substance of noncontrolling rights
ASC 810-10-25-14	11.3.2	Evaluating the effect of noncontrolling rights
ASC 810-10-25-14A through C	7.3.1.3.3	Kick-out rights
ASC 810-10-25-15	14.6	Differing accounting policies between parent and subsidiary
ASC 810-10-25-15	G.3	Consolidation of investment companies
ASC 810-10-25-16	17.1.6	Effect of intercompany inventory transfers on LIFO liquidation
ASC 810-10-25-21	5.1	Introduction
ASC 810-10-25-22	5.2	Step-by-step approach to identifying variable interests
ASC 810-10-25-23	5.2.2	Step 2: Identify variable interests

ASC paragraph	Section	
ASC 810-10-25-24	5.2.1.2	Consideration 2: What is the nature of the risks in the entity?
ASC 810-10-25-25	5.2.1.1	Consideration 1: What is the purpose for which the entity was created?
ASC 810-10-25-26	5.2.2.1	Consideration 1: Which variable interests absorb the variability designated in Step 1?
ASC 810-10-25-27	5.2.1.1	Consideration 1: What is the purpose for which the entity was created?
ASC 810-10-25-29	5.2.1	Step 1: Determine the variability an entity was designed to create and distribute
ASC 810-10-25-31	5.2.1.2.2	Terms of interests issued
ASC 810-10-25-32	5.2.1.2.3	Subordination
ASC 810-10-25-33	5.2.1.2.1	Certain interest rate risk
ASC 810-10-25-33	D.6.1.3	Cash flow prime method
ASC 810-10-25-34 through 36	5.4.4	Derivative instruments
ASC 810-10-25-35 through 36	5.4.4.1	Common derivative contracts
ASC 810-10-25-35 through 36	5.4.4.3	Total return swaps
ASC 810-10-25-35 through 36	5.4.6	Purchase contracts
ASC 810-10-25-35 through 36	5.4.11	Netting or offsetting contracts
ASC 810-10-25-37	7.5	Initial determination of VIE status
ASC 810-10-25-38	5.4.13	Fees paid to decision makers or service providers
ASC 810-10-25-38 through 38A	8.1	Introduction
ASC 810-10-25-38A	1.2.5	Step 5: If the entity is a VIE, is the reporting entity the primary beneficiary?
ASC 810-10-25-38A through 38J	5.4.13	Fees paid to decision makers or service providers
ASC 810-10-25-38A through 38J	8.3	Benefits
ASC 810-10-25-38A	8.4	Other frequently asked questions
ASC 810-10-25-38A(a)	1.1.2	Voting Model
ASC 810-10-25-38A(b)	1.1.2	Voting Model
ASC 810-10-25-38A(b)	8.3	Benefits
ASC 810-10-25-38B	8.2.2	Step 2: Identify the activities that most significantly impact the VIE's economic performance
ASC 810-10-25-38C	8.2.4.1	Kick-out rights
ASC 810-10-25-38C	8.2.4	Kick-out rights, participating rights and protective rights
ASC 810-10-25-38D	8.2.3.3	Shared power
ASC 810-10-25-38D through 38E	1.1.2	Voting Model
ASC 810-10-25-38E	8.2.3	Steps 3 and 4: Determine how decisions about significant activities are made and the party or parties that make them
ASC 810-10-25-38E	8.2.3.6	Multiple unrelated parties direct different activities that most significantly impact the VIE's economic performance
ASC 810-10-25-38E	8.2.3.6.2	Evaluating rights held by the board of directors and an operations manager in an operating entity
ASC 810-10-25-38F	8.2.1.1	Involvement with the design of the VIE

ASC paragraph	Section	
ASC 810-10-25-38G	8.3.2	Evaluating disproportionate power and benefits
ASC 810-10-25-38H through J	8.3.1	Fees paid to decision makers or service providers
ASC 810-10-25-42	9.1	Introduction
ASC 810-10-25-43	2.12	Related parties and de facto agents
ASC 810-10-25-43	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
ASC 810-10-25-43	7.4.3	Related party and de facto agent considerations
ASC 810-10-25-43	9.5.1	Principal-agency relationship
ASC 810-10-25-43	10.3	De facto agents
ASC 810-10-25-43	10.3.4	Separate accounts of insurance entities as potential related parties
ASC 810-10-25-43(d)	4.4.4.1	Significant participation in the design or redesign of an entity
ASC 810-10-25-43(d)	7.4.3	Related party and de facto agent considerations
ASC 810-10-25-44 through 44B	9.1	Introduction
ASC 810-10-25-44 through 44B	9.4	Multiple decision makers within the related party group
ASC 810-10-25-44 through 44A	9.5	Determining which party is most closely associated with a VIE
ASC 810-10-25-44	9.2.1	Single decision maker without a variable interest
ASC 810-10-25-44	9.5.2	Relationship and significance of a VIE's activities to members of a related party group
ASC 810-10-25-44	9.5.3	Exposure to variability associated with the anticipated economic performance of the VIE
ASC 810-10-25-44	9.6	One member of a related party group not clearly identified
ASC 810-10-25-44B	1.1.2	Voting Model
ASC 810-10-25-44B	8.2.3	Steps 3 and 4: Determine how decisions about significant activities are made and the party or parties that make them
ASC 810-10-25-44B	9.2	Single decision maker
ASC 810-10-25-44B	9.2.1	Single decision maker without a variable interest
ASC 810-10-25-44B	F.3	Primary beneficiary considerations
ASC 810-10-25-45	7.2.3.1	10% test – a misnomer
ASC 810-10-25-45 through 46	7.2.3.5	Illustrative examples
ASC 810-10-25-45 through 47	7.2.3	Methods for determining whether an equity investment at risk is sufficient
ASC 810-10-25-49 through 54	5.4.12	Implicit variable interests
ASC 810-10-25-55	5.4.5	Financial guarantees, written puts and similar obligations
ASC 810-10-25-55 through 56	5.5	Variable interests in specified assets
ASC 810-10-25-57 through 58	6.1	Introduction
ASC 810-10-30-1	13.2	Primary beneficiary and VIE are under common control
ASC 810-10-30-1 through 4	13.1	Introduction

ASC paragraph	Section	
ASC 810-10-30-2	13.3	Primary beneficiary of a VIE that is a business
ASC 810-10-30-3 through 4	13.4	Primary beneficiary of a VIE that is not a business
ASC 810-10-30-10 through 16	13.5.1	Measurement alternative for consolidated collateralized financing entities
ASC 810-10-35-3	17.1.2	Effect of NCI on intercompany eliminations for VIEs
ASC 810-10-35-3	17.1.2.1	Accounting for liabilities of a VIE after initial consolidation
ASC 810-10-35-4	12.1	Reconsideration of whether an entity is a VIE
ASC 810-10-35-6 through 9	13.5.1	Measurement alternative for consolidated collateralized financing entities
ASC 810-10-40-1 through 2A	18.5.2	Issuance or redemption of preferred stock by a subsidiary
ASC 810-10-40-2	16.1.3	Attribution to noncontrolling interests held by preferred shareholders
ASC 810-10-40-3A	19.1	Introduction
ASC 810-10-40-3A	19.2	Losing a controlling financial interest
ASC 810-10-40-3A	19.3	Scope of guidance in ASC 810 on loss of control
ASC 810-10-40-3A	19.4	Calculate the gain or loss upon losing control
ASC 810-10-40-3A	19.4.2	Measure the fair value of consideration received
ASC 810-10-40-3A	19.4.2.1	Accounting for contingent consideration upon a loss of control
ASC 810-10-40-3A	19.4.3.1	Measuring a retained creditor interest
ASC 810-10-40-3A	19.4.3.2	Subsequent accounting for a retained noncontrolling investment
ASC 810-10-40-3A	19.4.5.2	Accounting for accumulated other comprehensive income upon a loss of control
ASC 810-10-40-3A	19.4.5.2.1	Foreign currency translation adjustments
ASC 810-10-40-3A	19.4.7	Classification and presentation of a gain or loss upon loss of control
ASC 810-10-40-3A	19.5	Examples
ASC 810-10-40-3A	19.5.2	Deconsolidation by selling a partial interest
ASC 810-10-40-3A	19.5.3	Deconsolidation as a result of dilution
ASC 810-10-40-3A(c)	18.3	Scope of guidance in ASC 810 on a change in interest (without loss of control)
ASC 810-10-40-4	19.2	Losing a controlling financial interest
ASC 810-10-40-4A	19.4.5.2	Accounting for accumulated other comprehensive income upon a loss of control
ASC 810-10-40-4A	19.4.5.2.1	Foreign currency translation adjustments
ASC 810-10-40-5	19.2	Losing a controlling financial interest
ASC 810-10-40-5	19.3	Scope of guidance in ASC 810 on loss of control
ASC 810-10-40-5	19.4	Calculate the gain or loss upon losing control
ASC 810-10-40-5	19.4.2	Measure the fair value of consideration received
ASC 810-10-40-5	19.4.2.1	Accounting for contingent consideration upon a loss of control
ASC 810-10-40-5	19.4.5.2.1	Foreign currency translation adjustments

ASC paragraph	Section	
ASC 810-10-40-6	18.4.4	Accounting for transaction costs incurred upon a change in a parent's ownership interest
ASC 810-10-40-6	19.2.1	Deconsolidation through multiple arrangements
ASC 810-10-45	1	Overview
ASC 810-10-45-1 through 2	17.1	Procedures for eliminating intercompany balances and transactions
ASC 810-10-45-1	17.1.1	Effect of NCI on intercompany eliminations – overview
ASC 810-10-45-1	17.2	Examples
ASC 810-10-45-2	15.1.2	Initial recognition and measurement of a noncontrolling interest
ASC 810-10-45-4	17.1	Procedures for eliminating intercompany balances and transactions
ASC 810-10-45-5	17.1.3	Shares of a parent held by its subsidiary (reciprocal interest)
ASC 810-10-45-8	17.1	Procedures for eliminating intercompany balances and transactions
ASC 810-10-45-10	20.2	Preparing combined financial statements
ASC 810-10-45-11	21.1	Purpose of parent-company financial statements
ASC 810-10-45-11	22.1	Purpose of consolidating financial statements
ASC 810-10-45-12 through 13	14.3	Differing fiscal year-ends between parent and subsidiary
ASC 810-10-45-14	14.2	Undivided interests and proportionate consolidation
ASC 810-10-45-15 through 17A	15.1	Noncontrolling interests
ASC 810-10-45-18	17.1.1	Effect of NCI on intercompany eliminations - overview
ASC 810-10-45-19 through 20	16.1	Attribution procedure
ASC 810-10-45-20	16.1.1	Substantive profit-sharing arrangements
ASC 810-10-45-21	16.1.2	Attribution of losses in excess of noncontrolling interest's carrying amount
ASC 810-10-45-21A	18.3	Scope of guidance in ASC 810 on a change in interest (without loss of control)
ASC 810-10-45-21A	18.3.3	Subsidiaries acquired before adoption of FAS 160 and FAS 141R
ASC 810-10-45-21A	18.4	Accounting for changes in a parent's ownership interest in a subsidiary in a transaction within the scope of ASC 810
ASC 810-10-45-21A	18.4.2	Accumulated other comprehensive income considerations in a change in interest
ASC 810-10-45-21A	18.4.4	Accounting for transaction costs incurred upon a change in a parent's ownership interest
ASC 810-10-45-21A	18.1	Introduction
ASC 810-10-45-21A	18.6	Examples of changes in a parent's ownership interest when the parent maintains control of a subsidiary in a transaction in the scope of ASC 810
ASC 810-10-45-21A(a)	18.6.6	Consolidation after subsidiary acquires outstanding shares from noncontrolling interest holder

ASC paragraph	Section	
ASC 810-10-45-21A(b)	18.3	Scope of guidance in ASC 810 on a change in interest (without loss of control)
ASC 810-10-45-21A(b)	18.6.4	Consolidation after parent sells a portion of its interest
ASC 810-10-45-21A(b)	18.6.5	Consolidation after subsidiary issues additional shares
ASC 810-10-45-21A(b)	18.3.2.2.6	Decrease in interest – substance not addressed by other GAAP
ASC 810-10-45-21A(b)(2)	19.3	Scope of guidance in ASC 810 on loss of control
ASC 810-10-45-21A(b)(2)	18.3	Scope of guidance in ASC 810 on a change in interest (without loss of control)
ASC 810-10-45-22	18.5.3.1	Issuance of preferential limited partnership units by a Master Limited Partnership account
ASC 810-10-45-22	18.1	Introduction
ASC 810-10-45-23	18.5.2	Issuance or redemption of preferred stock by a subsidiary
ASC 810-10-45-23	18.4	Accounting for changes in a parent's ownership interest in a subsidiary in a transaction within the scope of ASC 810
ASC 810-10-45-23	18.2	Retaining a controlling financial interest
ASC 810-10-45-23	18.5.3	Issuance by a subsidiary of partnership units that have varying profit or liquidation preferences
ASC 810-10-45-23	18.5.3.1	Issuance of preferential limited partnership units by a Master Limited Partnership account
ASC 810-10-45-23 through 24	18.4.2.1	Accounting for foreign currency translation adjustments
ASC 810-10-45-24	18.4.2	Accumulated other comprehensive income considerations in a change in interest
ASC 810-10-45-25	23.1	Presentation of VIEs
ASC 810-10-50-1 through 10	23.2.10	Wholly foreign-owned enterprises, including China-based issuers
ASC 810-10-50-1 through 1A	23.3	Other procedures and disclosure requirements related to consolidation
ASC 810-10-50-1A	15.1	Noncontrolling interests
ASC 810-10-50-1A(c)	23.3.2.1	Presentation of redeemable noncontrolling interests in the equity reconciliation
ASC 810-10-50-1A(c)	23.3.2.2	Interim reporting period requirements
ASC 810-10-50-1A(c)	23.3.3	Consolidated statement of financial position presentation
ASC 810-10-50-1A(c)	23.4	Example of presentation and disclosures under ASC 810
ASC 810-10-50-1B	19.4.2	Measure the fair value of consideration received
ASC 810-10-50-1B	23.3.5	Disclosures for deconsolidation of a subsidiary in the scope of ASC 810
ASC 810-10-50-1B(d) through 1B(h)	23.4	Example of presentation and disclosures under ASC 810
ASC 810-10-50-2	14.3	Differing fiscal year-ends between parent and subsidiary
ASC 810-10-50-2AA through 2AC	23.2.1	Disclosure objectives
ASC 810-10-50-2AG through 2AI	E.5	Disclosures

ASC paragraph	Section	
ASC 810-10-50-3	23.2.2	Primary beneficiaries of VIEs
ASC 810-10-50-4	23.2.3	Holders of variable interests in VIEs that are not primary beneficiaries
ASC 810-10-50-4(b)	23.2.3	Holders of variable interests in VIEs that are not primary beneficiaries
ASC 810-10-50-5A	23.2.2	Primary beneficiaries of VIEs
ASC 810-10-50-5A	23.2.3	Holders of variable interests in VIEs that are not primary beneficiaries
ASC 810-10-50-5A through 5B	23.2.4	All holders of variable interests in VIEs
ASC 810-10-50-6	4.4.3	Information availability
ASC 810-10-50-6	23.2.5	Scope-related VIE disclosures
ASC 810-10-50-9	23.2.6	Aggregation of certain VIE disclosures
ASC 810-10-50-10	23.2.6	Aggregation of certain VIE disclosures
ASC 810-10-50-20 through 22	23.2.9	Measurement alternative for consolidated collateralized financing entities
ASC 810-10-55-1	7.3.1.3.5	Protective rights
ASC 810-10-55-1	11.3.2.1.1	Evaluating the substance of noncontrolling rights
ASC 810-10-55-1A	19.3	Scope of guidance in ASC 810 on loss of control
ASC 810-10-55-1B	20.1	Purpose of combined financial statements
ASC 810-10-55-1B	G.4	Combined financial statements under the Custody Rule
ASC 810-10-55-2	17.1.6	Effect of intercompany inventory transfers on LIFO liquidation
ASC 810-10-55-3	17.1.6	Effect of intercompany inventory transfers on LIFO liquidation
ASC 810-10-55-4	17.1.6	Effect of intercompany inventory transfers on LIFO liquidation
ASC 810-10-55-4A	19.2	Losing a controlling financial interest
ASC 810-10-55-4C	18.6.4	Consolidation after parent sells a portion of its interest
ASC 810-10-55-4D through 4E	18.6.5	Consolidation after subsidiary issues additional shares
ASC 810-10-55-4F	18.4.2	Accumulated other comprehensive income considerations in a change in interest
ASC 810-10-55-4I	23.3.3	Consolidated statement of financial position presentation
ASC 810-10-55-4V	11.2.2	Voting Model: Control of limited partnerships and similar entities
ASC 810-10-55-4N through 4W	7.3.1.3.3	Kick-out rights
ASC 810-10-55-4N	7.3.1.3.3	Kick-out rights
ASC 810-10-55-4O	7.3.1.3.2	Limited partnerships and similar entities
ASC 810-10-55-4O	7.3.1.3.3	Kick-out rights
ASC 810-10-55-4P	7.3.1.3.2	Limited partnerships and similar entities
ASC 810-10-55-4P	7.3.1.3.3	Kick-out rights
ASC 810-10-55-4Q	7.3.1.3.3	Kick-out rights
ASC 810-10-55-4R	7.3.1.3.3	Kick-out rights
ASC 810-10-55-4S	7.3.1.3.2	Limited partnerships and similar entities

ASC paragraph	Section
ASC 810-10-55-4S	7.3.1.3.3 Kick-out rights
ASC 810-10-55-4T	7.3.1.3.2 Limited partnerships and similar entities
ASC 810-10-55-4T	7.3.1.3.3 Kick-out rights
ASC 810-10-55-4U	7.3.1.3.2 Limited partnerships and similar entities
ASC 810-10-55-4U	7.3.1.3.3 Kick-out rights
ASC 810-10-55-4V	7.3.1.3.2 Limited partnerships and similar entities
ASC 810-10-55-4V	7.3.1.3.3 Kick-out rights
ASC 810-10-55-4W	7.3.1.3.2 Limited partnerships and similar entities
ASC 810-10-55-4W	7.3.1.3.3 Kick-out rights
ASC 810-10-55-8A through 8H	4.2.7 Series funds
ASC 810-10-55-8A through 8H	7.3.1.3.1 Corporations and similar entities
ASC 810-10-55-17 through 19	5.2.2.1 Consideration 1: Which variable interests absorb the variability designated in Step 1?
ASC 810-10-55-20	5.4 Illustrative examples of variable interests
ASC 810-10-55-21	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?
ASC 810-10-55-22	5.4.1 Equity investments
ASC 810-10-55-22	5.4.3 Trust preferred securities
ASC 810-10-55-23 through 24	5.4.2 Beneficial interests and debt instruments
ASC 810-10-55-25	5.4.12 Implicit variable interests
ASC 810-10-55-25 through 26	5.4.5 Financial guarantees, written puts and similar obligations
ASC 810-10-55-27 through 28	5.4.4.2 Forward contracts
ASC 810-10-55-29	5.4.4.1 Common derivative contracts
ASC 810-10-55-30	5.4.4.3 Total return swaps
ASC 810-10-55-31	5.4.4.4 Embedded derivatives
ASC 810-10-55-32	5.2.2.1 Consideration 1: Which variable interests absorb the variability designated in Step 1?
ASC 810-10-55-37	5.4.9.2 Joint service agreements
ASC 810-10-55-37	5.4.13.1 Conditions (a) and (d): Fees are commensurate with the level of effort required and include only customary terms and conditions
ASC 810-10-55-37	5.4.13.2 Condition (c): Other interests held by a decision maker or service provider
ASC 810-10-55-37	5.4.13.3 Fees that expose a reporting entity to risk of loss
ASC 810-10-55-37	5.4.13.4 Reconsideration of a decision maker's or service provider's fees as variable interests
ASC 810-10-55-37	7.3.1.4 Effect of decision makers or service providers when evaluating ASC 810-10-15-14(b)(1)
ASC 810-10-55-37	D.8 Example analysis of sufficiency of equity
ASC 810-10-55-37 through 37D	8.3 Benefits
ASC 810-10-55-37B	5.4.13.1 Conditions (a) and (d): Fees are commensurate with the level of effort required and include only customary terms and conditions
ASC 810-10-55-37C	5.4.13.3 Fees that expose a reporting entity to risk of loss

ASC paragraph	Section	
ASC 810-10-55-37(c)	5.4.13.2	Condition (c): Other interests held by a decision maker or service provider
ASC 810-10-55-37(c)	5.4.13.4	Reconsideration of a decision maker's or service provider's fees as variable interests
ASC 810-10-55-37D	2.7	Indirect interest
ASC 810-10-55-37D	5.4.13.2	Condition (c): Other interests held by a decision maker or service provider
ASC 810-10-55-37D	5.4.13.2.1	Interests held by related parties when evaluating fees paid to a decision maker or service provider
ASC 810-10-55-37D	5.4.13.2.2	Interests held by employees when evaluating fees paid to a decision maker or service provider
ASC 810-10-55-37 through 38	5.4.13	Fees paid to decision makers or service providers
ASC 810-10-55-38	7.3.1.4	Effect of decision makers or service providers when evaluating ASC 810-10-15-14(b)(1)
ASC 810-10-55-38	8.3	Benefits
ASC 810-10-55-39	5.4.7.1	Operating leases — reporting entity is the lessee
ASC 810-10-55-40	4.2.5	Application of Variable Interest Model to tiered structures
ASC 810-10-55-42 through 49	D.3	Calculating expected losses and expected residual returns
ASC 810-10-55-50 through 54	D.2	Expected losses, expected residual returns and expected variability
ASC 810-10-55-55 through 86	5.2.1	Step 1: Determine the variability an entity was designed to create and distribute
ASC 810-10-55-62 through 64	5.4.4.1	Common derivative contracts
ASC 810-10-55-62 through 86	5.4.4.1	Common derivative contracts
ASC 810-10-55-65 through 67	5.4.4.1	Common derivative contracts
ASC 810-10-55-68 through 70	5.4.4.1	Common derivative contracts
ASC 810-10-55-71 through 74	5.4.4.1	Common derivative contracts
ASC 810-10-55-75 through 77	5.2.2.1	Consideration 1: Which variable interests absorb the variability designated in Step 1?
ASC 810-10-55-81 through 86	5.4.4.1	Common derivative contracts
ASC 810-10-55-78 through 80	5.4.7.1	Operating leases – reporting entity is the lessee
ASC 810-10-55-78 through 80	8.2.3	Steps 3 and 4: Determine how decisions about significant activities are made and the party or parties that make them
ASC 810-10-55-81 through 86	5.2.2.1	Consideration 1: Which variable interests absorb the variability designated in Step 1?
ASC 810-10-55-81 through 86	5.4.4.2	Forward contracts
ASC 810-10-55-93 through 205	8.2.3	Steps 3 and 4: Determine how decisions about significant activities are made and the party or parties that make them
ASC 810-10-55-172 through 181	5.4.7.1	Operating leases – reporting entity is the lessee
ASC 810-10-55-184 through 192	8.2.3.3	Shared power

ASC paragraph	Section	
ASC 810-10-55-193	8.2.3.6	Multiple unrelated parties direct different activities that most significantly impact the VIE's economic performance
ASC 810-10-55-194 through 196	8.2.3.5	Multiple unrelated parties direct the same activities that most significantly impact the VIE's economic performance
ASC 810-10-55-197 through 198	8.2.3.6	Multiple unrelated parties direct different activities that most significantly impact the VIE's economic performance
ASC 810-10-55-199 through 205	8.2.4.3	Protective rights
ASC 810-10-55-205L through 205V	5.4.13	Fees paid to decision makers or service providers
ASC 810-10-55-205L through 205AI	8.2.3	Steps 3 and 4: Determine how decisions about significant activities are made and the party or parties that make them
ASC 810-10-55-205Z through 205AI	8.3.1	Fees paid to decision makers or service providers
ASC 810-10-55-205AS	13.5.1	Measurement alternative for consolidated collateralized financing entities
ASC 810-10-55-205AT	13.5.1	Measurement alternative for consolidated collateralized financing entities
ASC 810-10-55-205AU through 55-205BF	E.4	Illustrations
ASC 810-10-55-205BF	E.5	Disclosures
ASC 810-10-55-205W through Y	5.4.13	Fees paid to decision makers or service providers
ASC 810-10-55-206 through 209	11.4	Control by contract
ASC 810-10-60-2	17.1.5	Deferred taxes on dividends of foreign operations
ASC 810-10-60-3	17.1	Procedures for eliminating intercompany balances and transactions
ASC 810-10-S99-2	11.1.1	SEC regulations on consolidation
ASC 810-10-S99-3	23.3.6	Disclosures required upon a change in the entities consolidated
ASC 810-10-S99-5	19.4.1	Identify other elements of the transaction
ASC 810-30-15-3(b)	4.1	Introduction
ASC 810-30-15-3(b)	8.1	Introduction
ASC 815-15-25-1	5.4.4.4	Embedded derivatives
ASC 815-40-15-5C	15.1	Noncontrolling interests
ASC 820-10-55-4 through 20	D.6	Approaches to calculate expected losses and expected returns
ASC 830-20-30-2	11.3.1	Foreign currency exchange restrictions
ASC 830-30-40-2	18.4.2.1	Accounting for foreign currency translation adjustments
ASC 845-10-30-1 through 3	16.1.7	Attribution of dividends payable in nonmonetary assets
ASC 845-10-30-10	16.1.7	Attribution of dividends payable in nonmonetary assets
ASC 848-10-15-3	12.1.1.11	Contract modifications due to LIBOR transition
ASC 848-20-15-2	12.1.1.11	Contract modifications due to LIBOR transition

ASC paragraph	Section	
ASC 848-20-15-3	12.1.1.11	Contract modifications due to LIBOR transition
ASC 848-20-35-4	12.1.1.11	Contract modifications due to LIBOR transition
ASC 848-20-55-2	12.1.1.11	Contract modifications due to LIBOR transition
ASC 860-10-15-4(f)	18.3.2.2.3	Decrease in interest – substance addressed by ASC 860
ASC 860-10-15-4(f)	19.3.2.3	Loss of control – substance addressed by ASC 860
ASC 860-10-55-14	18.3.2.2.3	Decrease in interest – substance addressed by ASC 860
ASC 910-10-15-3 through 4	14.2	Undivided interests and proportionate consolidation
ASC 932-360-40	18.3.2.1.1	Scope exception for oil and gas conveyances
ASC 932-360-55-3	18.3.2.1.1	Scope exception for oil and gas conveyances
ASC 932-360-55-3	19.3.1.1	Scope exception for oil and gas conveyances
ASC 944-80-25-2 through 3	23.3.3	Consolidated statement of financial position presentation
ASC 944-80-25-3	10.3.4	Separate accounts of insurance entities as potential related parties
ASC 944-80-25-12	23.3.3	Consolidated statement of financial position presentation
ASC 946-10-15-4 through 9	G.1.1	Attributes of an investment company
ASC 946-205-50-15	G.4	Combined financial statements under the Custody Rule
ASC 946-205-50-25	G.4	Combined financial statements under the Custody Rule
ASC 946-210-45-7	G.2.1.1	SEC staff views on consolidation in master/feeder and fund of funds structures
ASC 946-810-45-2 through 3	G.2	Consolidation by an investment company
ASC 946-810-45-3	1.2.1	Step 1: Does a scope exception to consolidation guidance (ASC 810) apply?
ASC 946-810-45-3	11.1.2	Scope of the Voting Model
ASC 946-810-45-3	4.3.2	Investment companies
ASC 946-810-45-3	G.1	Overview
ASC 952-10-20	4.4.4.1.2	Determining whether an entity is a franchisee
ASC 958-810	11.2.1.1	Consolidation of a not-for-profit organization
ASC 958-810-25-12	11.2.2.1	Not-for-profits that are the general partner of a for-profit limited partnership
ASC 958-810-25-14	11.2.2.1	Not-for-profits that are the general partner of a for-profit limited partnership
ASC 958-810-25-15	11.2.2.1	Not-for-profits that are the general partner of a for-profit limited partnership
ASC 970-323-25-12	14.2	Undivided interests and proportionate consolidation
ASC 970-323-35-16 through 17	16.1.1	Substantive profit-sharing arrangements
ASC 970-810-45-1	14.2	Undivided interests and proportionate consolidation
ASC 980-810-45-1 through 2	17.1	Procedures for eliminating intercompany balances and transactions

C Summary of important changes

The following highlights important changes to this publication since the August 2022 edition:

- ▶ Sections 1.1.2 and 9.1 flowcharts were updated to reflect the issuance of ASU 2023-02, which broadens the scope of ASC 323-740 when adopted and could result in additional exemptions from the “substantially all” assessment.
- ▶ Section 5.4.7.4 was removed due to the adoption of ASU 2018-17.
- ▶ Sections 5.4.13.2.1 and 9.2 were updated to reflect the adoption of ASU 2018-17.
- ▶ Section 7.3.1.2 was updated to include considerations about significant activities of an entity changing over the entity’s life cycle.
- ▶ Section 7.3.1.2.1 was added to include examples of activities that most significantly affect the economic performance of entities within certain industries.
- ▶ Section 9.2 was updated to reflect the issuance of ASU 2023-02.
- ▶ Section 9.2.1 was added to include interpretive guidance for situations where the decision maker or service provider concludes that it does not have a variable interest in the legal entity, but the related party group under common control meets the economics criterion.
- ▶ Sections 12.1.1.11 and 12.2.1 were updated to reflect the issuance of ASU 2022-06.
- ▶ Section 19.4.2.1 was updated to include a flowchart to illustrate the guidance that may be applied to contingent consideration upon a loss of control.
- ▶ Chapter 24 was removed due to the adoption of ASU 2018-17.
- ▶ Section 24.2.1 was moved to Section 13.6 and updated as the SEC reporting implications upon adoption of an ASU may still be applicable even after the adoption of ASU 2018-17.
- ▶ Appendix E was updated to reflect the adoption of ASU 2018-17.
- ▶ Sections F.1 and F.3 were updated to reflect the issuance of ASU 2023-02.

D Expected losses and expected residual returns

D.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 section 7 for guidance on determining whether an entity is a VIE.

D.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.

See ASC 810-10-55-50 through 54 for an example of calculating expected losses when there is no history of losses or expectation of future losses.

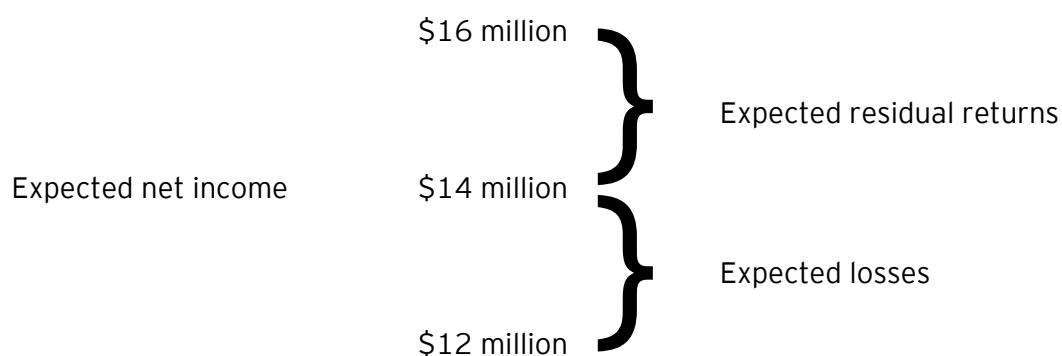


FASB update

In November 2019, the FASB proposed amendments that, among other changes, would remove the reference to Concepts Statement No. 7 from the definition of "expected losses and expected residual returns" in ASC 810-10-20. The FASB does not intend¹ for the changes to have a significant effect on current practice.

Illustration D-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:



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.

¹ Paragraph 4 of Proposed ASU, *Codification Improvements*.

D.3 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.² 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.

See ASC 810-10-55-42 through 49 for an example of calculating expected losses, expected residual returns and expected variability.

² See paragraph 45 of CON 7.

Question D.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 D-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)	<u>(200)</u>
Cash available to variable interest holders	<u>\$ 800</u>

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.

	Possible outcome (a)	Probability (b)	Weighted possible outcome (a x b) = (c)	Fair value ¹ (d)
Year 1	\$ 1,000	10%	\$ 100	\$ 95.24
Year 2	\$ 1,000	60%	600	544.22
Year 3	\$ 1,000	<u>30%</u>	300	<u>259.15</u>
		<u>100%</u>		<u>\$ 898.61</u>

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.

	Possible outcome	Discounted possible outcome² (e)	Fair value (f)	Probability (b)	Expected losses ((f-e) x b)	Expected residual returns ((e-f) x b)
Year 1	\$ 1,000	\$ 952.38	\$ 898.61	10%	\$ -	\$ 5.38
Year 2	\$ 1,000	907.02	898.61	60%	-	5.05
Year 3	\$ 1,000	863.84	898.61	30%	10.43	-
				<u>100%</u>	<u>\$ 10.43</u>	<u>\$ 10.43</u>

² Discounted at the interest rate on default risk-free investments (assumed to be 5% for all years).

This simple example illustrates how expected losses and expected residual returns are calculated for an entity that expects to realize a \$1,000 cash flow on one of three dates. In practice, entities will have multiple assets, cash flows and fair values that could vary significantly among a large number of possible outcomes.

D.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 sections 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 D.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.

D.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 section 7.4.1).

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 D-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 1 – Allocation of outcomes to variable interest holders

Possible outcomes (a)	Probability (b)	Outcomes to:	
		Debt (c)	Equity (d)
\$ 650,000	5%	\$ 650,000	\$ –
700,000	10%	700,000	–
750,000	25%	750,000	–
800,000	25%	800,000	–
850,000	20%	800,000	50,000
900,000	15%	800,000	100,000

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

Present value of possible outcomes	Probability	Fair value	Expected losses	Expected residual returns
(e)=(c)/(1+RF rate)	(b)	(e x b)	((e-f) x b)	
\$ 619,048	5%	\$ 30,952	\$ (5,714)	\$ -
666,667	10%	66,667	(6,667)	-
714,286	25%	178,572	(4,762)	-
761,905	25%	190,476	-	7,143
761,905	20%	152,381	-	5,714
761,905	15%	<u>114,286</u>	<u>-</u>	<u>4,286</u>
		<u>\$ 733,334</u> (f)	<u>\$ (17,143)</u>	<u>\$ 17,143</u>

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

Present value of possible outcomes	Probability	Fair value	Expected losses	Expected residual returns
(g) = (d)/(1+RF rate)	(b)	(g x b)	((g-h) x b)	
\$ -	5%	\$ -	\$ (1,191)	\$ -
-	10%	-	(2,381)	-
-	25%	-	(5,952)	-
-	25%	-	(5,952)	-
47,619	20%	9,524	-	4,762
95,238	15%	<u>14,286</u>	<u>-</u>	<u>10,714</u>
		<u>\$ 23,810</u> (h)	<u>\$ (15,476)</u>	<u>\$ 15,476</u>

The expected losses and expected residual returns of the variable interest holders, and of the entity, may be summarized as follows:

	Expected losses	Expected residual returns
Debt holder (Table 2)	\$ (17,143)	\$ 17,143
Equity holder (Table 3)	<u>(15,476)</u>	<u>15,476</u>
Total variable interests	<u>\$ (32,619)</u>	<u>\$ 32,619</u>

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 stockholders, 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 D-4 for guidance on these two approaches.

Illustration D-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:

Possible outcomes	Expected losses	Expected residual returns
\$ 650,000	\$ (6,905)	\$ -
700,000	(9,048)	-
750,000	(10,714)	-
800,000	-	1,191
850,000	-	10,476
900,000	-	15,000
	<u>\$ (26,667)</u>	<u>\$ 26,667</u>

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 D-3 for how these amounts are calculated):

Possible outcome	Debt holder		Equity holder		Total VIs	
	Expected losses	Expected residual returns	Expected losses	Expected residual returns	Expected losses	Expected residual returns
\$ 650,000	\$ (5,714)	\$ -	\$ (1,191)	\$ -	\$ (6,905)	\$ -
700,000	(6,667)	-	(2,381)	-	(9,048)	-
750,000	(4,762)	-	(5,952)	-	(10,714)	-
800,000	-	7,143	(5,952)	-	(5,952)	7,143
850,000	-	5,714	-	4,762	-	10,476
900,000	-	4,286	-	10,714	-	15,000
	<u>\$ (17,143)</u>	<u>\$ 17,143</u>	<u>\$ (15,476)</u>	<u>\$ 15,476</u>	<u>\$ (32,619)</u>	<u>\$ 32,619</u>

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.

This approach is demonstrated in the shaded portions of the table below:

Potential outcome	Debt holder		Equity holder		Total	
	Expected losses	Expected residual returns	Expected losses	Expected residual returns	Expected losses	Expected residual returns
\$ 650,000	\$ (5,714)	\$ -	\$ (1,191)	\$ -	\$ (6,905)	\$ -
700,000	(6,667)	-	(2,381)	-	(9,048)	-
750,000	(4,762)	-	(5,952)	-	(10,714)	-
800,000	5,952	1,191	(5,952)	-	-	1,191
850,000	-	5,714	-	4,762	-	10,476
900,000	-	4,286	-	10,714	-	15,000
	<u>\$ (11,191)</u>	<u>\$ 11,191</u>	<u>\$ (15,476)</u>	<u>\$ 15,476</u>	<u>\$ (26,667)</u>	<u>\$ 26,667</u>

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:

Potential outcome	Debt holder		Equity holder		Total	
	Expected losses	Expected residual returns	Expected losses	Expected residual returns	Expected losses	Expected residual returns
\$ 650,000	\$ (5,714)	\$ -	\$ (1,191)	\$ -	\$ (6,905)	\$ -
700,000	(6,667)	-	(2,381)	-	(9,048)	-
750,000	(4,762)	-	(5,952)	-	(10,714)	-
800,000	-	7,143	-	(5,952)	-	1,191
850,000	-	5,714	-	4,762	-	10,476
900,000	-	4,286	-	10,714	-	15,000
	<u>\$ (17,143)</u>	<u>\$ 17,143</u>	<u>\$ (9,524)</u>	<u>\$ 9,524</u>	<u>\$ (26,667)</u>	<u>\$ 26,667</u>

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.

D.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 D-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:

Possible outcomes	Present value of possible outcomes	Probability	Fair value
\$ 1,250,000	\$ 1,190,476	20%	\$ 238,095
1,375,000	1,309,524	20%	261,905
1,500,000	1,428,571	20%	285,714
1,750,000	1,666,667	20%	333,333
2,000,000	1,904,762	<u>20%</u>	<u>380,952</u>
		<u>100%</u>	<u>\$ 1,500,000</u>

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.

D.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 D.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 VIE's expected losses or expected residual returns under ASC 810-10. Paragraphs 42 through 61 of CON 7³ 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.

³ A similar discussion can be found in ASC 820-10-55-4 through 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 D.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 flows 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.

D.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.

D.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 D-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.

D.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.

D.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 section 5.4.4).
- ▶ 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 D.8 includes an example of the cash flow prime method for an entity holding real estate.

The following table compares the three methods:

	<u>Fair value</u>	<u>Cash flow</u>	<u>Cash flow prime</u>
Fixed rate US obligation	Cash flows are fixed. Discount rate varies by scenario. Expected losses and expected residual returns occur because fair value of cash flow varies.	Cash flows are fixed. Discounted using one yield curve. No expected losses and expected residual returns because cash flows are fixed.	Cash flows are fixed. Discounted using one yield curve. No expected losses and expected residual returns because cash flows are fixed.
Variable rate US government obligation	Cash flows are projected based on a forward yield curve and discounted using the same yield curve. No expected losses and expected residual returns.	Cash flows vary by scenario but are discounted using one yield curve, giving rise to expected losses and expected residual returns.	Cash flows are projected based on a forward yield curve and discounted using the same yield curve. No expected losses and expected residual returns.

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 D.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 D.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.

Illustration D-7: Inclusion of credit risk in an expected losses calculation

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:

Lender A	\$ 22
Guarantor A	<u>38</u>
Total	<u>\$ 60</u>

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 D.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 (see section F.3 for guidance on 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.⁴

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 D-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.

⁴ Comments by Jane D. Poulin, Associate Chief Accountant, at the 2004 AICPA National Conference on Current SEC and PCAOB Developments. We believe that references to FIN 46(R) in the speech also would apply to the current Variable Interest Model.

D.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 section 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.

D.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. Assume that the leases meet the classification requirements for an operating lease.
- ▶ 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. Assume that the lease meets the classification requirements for an operating lease.
- ▶ 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

Sources of funds:		Uses of funds:	
Manage Co. – Equity	\$ 6,000,000	Big Building Purchase	\$ 68,700,000
Passive Co. – Equity	4,000,000	Little Building Purchase	29,500,000
Lender A – Loan	63,000,000	Building Three Purchase	45,000,000
Lender B – Loan	27,000,000	Guarantee Fees	
Lender C – Loan	45,000,000	Big Building	1,300,000
		Little Building	500,000
	<u>\$ 145,000,000</u>		<u>\$ 145,000,000</u>

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

	Manage Co.	Passive Co.	Lender A	Lender B	Lender C	Total fair value
Big Building						
Building	\$ 3,420,000	\$ 2,280,000	\$ 63,000,000	N/A	N/A	\$ 68,700,000
Guarantee	<u>780,000</u>	<u>520,000</u>	<u>–</u>	N/A	N/A	<u>1,300,000</u>
Total	4,200,000	2,800,000	63,000,000			70,000,000
Little Building						
Building	1,500,000	1,000,000	N/A	\$ 27,000,000	N/A	29,500,000
Guarantee	<u>300,000</u>	<u>200,000</u>	N/A	<u>–</u>	N/A	<u>500,000</u>
Total	1,800,000	1,200,000		27,000,000		30,000,000
Building Three						
Building	<u>N/A</u>	<u>N/A</u>	<u>N/A</u>	<u>N/A</u>	\$ 45,000,000	<u>45,000,000</u>
Total Amounts Financed	<u>\$ 6,000,000</u>	<u>\$ 4,000,000</u>	<u>\$ 63,000,000</u>	<u>\$ 27,000,000</u>	<u>\$ 45,000,000</u>	<u>\$ 145,000,000</u>

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 section 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 section 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 section 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

Possible Rental Income	Decision Maker Fees	Possible Cash Flows from Sale of Building	Total Possible Undiscounted Outcomes	Present Value of Possible Outcomes
\$ 18,000,000	\$ 2,000,000	\$ 55,000,000	\$ 75,000,000	\$ 60,411,846
18,750,000	2,083,333	58,000,000	78,833,333	63,484,004
19,500,000	2,166,667	64,200,000	85,866,667	69,063,445
20,500,000	2,277,778	70,000,000	92,777,778	74,570,003
21,250,000	2,361,111	71,750,000	95,361,111	76,662,753
22,500,000	2,500,000	76,500,000	101,500,000	81,587,135

The possible outcomes for Little Building are presented in Table 4 below.

Table 4 – Little Building possible outcomes

Possible Rental Income	Decision Maker Fees	Possible Cash Flows from Sale of Building	Interest Paid to Lender B	Principal Paid to Lender B	Premium Paid to Guarantor B	Possible Cash Flows from Guarantor B	Total Possible Undiscounted Outcomes	Present Value of Possible Outcomes
\$ 7,000,000	\$ 777,778	\$ 22,000,000	\$ (6,750,000)	\$ (27,000,000)	\$ (500,000)	\$ 5,000,000	\$ 527,778	\$ 389,948
8,000,000	888,889	25,000,000	(6,750,000)	(27,000,000)	(500,000)	2,000,000	1,638,889	1,352,054
8,625,000	958,333	26,000,000	(6,750,000)	(27,000,000)	(500,000)	1,000,000	2,333,333	1,953,370
9,875,000	1,097,222	27,000,000	(6,750,000)	(27,000,000)	(500,000)		3,722,222	3,156,003
10,000,000	1,111,111	29,500,000	(6,750,000)	(27,000,000)	(500,000)		6,361,111	5,235,081
10,500,000	1,166,667	32,000,000	(6,750,000)	(27,000,000)	(500,000)		9,416,667	7,674,950

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 D.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 D.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

From Table 3 above	Probabilities are judgmentally determined and assigned to each outcome based on estimated likelihood of occurrence	Present value of the possible outcomes, multiplied by the associated probability of occurrence
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	Present Value of Possible Outcomes	Estimated Probability of Outcomes	Proof of Fair Value
Big Building			
\$ 60,411,846	10%	\$ 6,041,185	
63,484,004	18%	11,427,121	
69,063,445	25%	17,265,861	
74,570,003	25%	18,642,501	
76,662,753	15%	11,499,413	
81,587,135	<u>7%</u>	<u>5,711,099</u>	
	<u>100%</u>	<u>\$ 70,587,180</u>	
Variable Interests in Big Building			
Manage Co.		\$ 4,200,000	
Passive Co.		2,800,000	
Lender A		63,000,000	
Guarantor A		(1,300,000)	
Decision Maker fees		<u>1,918,199</u>	
		<u>\$ 70,618,199</u>	

Fair values of variable interests held by Manage Co., Passive Co., Lender A and Guarantor A are from Table 2 above	The fair value of Guarantor A's interest is included as a negative amount because the LLC paid a premium to obtain the guarantee
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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

	Present Value of Possible Outcomes	Estimated Probability of Outcomes	Proof of Fair Value
Little Building			
	\$ 389,948	5%	\$ 19,497
	1,352,054	10%	135,205
	1,953,370	25%	488,343
	3,156,003	30%	946,801
	5,235,081	20%	1,047,016
	7,674,950	10%	767,495
		<u>100%</u>	<u>\$ 3,404,357</u>
Variable Interests in Little Building			
Manage Co.			\$ 1,500,000
Passive Co.			1,000,000
Decision Maker fees			<u>896,562</u>
			<u>\$ 3,396,562</u>

From Table 4 above

Probabilities are judgmentally determined and assigned to each outcome based on estimated likelihood of occurrence

Present value of the possible outcomes, multiplied by the associated probability of occurrence

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 D.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

Present Value of Possible Outcomes	Fair Value	Difference	Estimated Probability of Outcomes	Entity Variability in Outcomes	
				Expected Losses	Expected Residual Returns
Big Building					
\$ 60,411,846	\$ 70,587,180	\$ (10,175,334)	10%	\$ (1,017,533)	\$ -
63,484,004	70,587,180	(7,103,176)	18%	(1,278,572)	-
69,063,445	70,587,180	(1,523,734)	25%	(380,934)	-
74,570,003	70,587,180	3,982,823	25%	-	995,706
76,662,753	70,587,180	6,075,574	15%	-	911,336
81,587,135	70,587,180	10,099,955	7%	-	769,997
			<u>100%</u>	<u>(2,677,039)</u>	<u>2,677,039</u>
Little Building					
\$ 389,948	\$ 3,404,357	(3,014,409)	5%	(150,720)	-
1,352,054	3,404,357	(2,052,303)	10%	(205,230)	-
1,955,370	3,404,357	(1,450,987)	25%	(362,747)	-
3,156,003	3,404,357	(248,355)	30%	(74,506)	-
5,235,081	3,404,357	1,830,724	20%	-	366,145
7,674,950	3,404,357	4,270,582	10%	-	427,059
			<u>100%</u>	<u>(793,204)</u>	<u>793,204</u>
				<u>\$ (3,470,243)</u>	<u>\$ 3,470,243</u>

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.

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 D.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 be 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.)

E Private company accounting alternative for common control arrangements (updated June 2023)

E.1 Overview (updated June 2023)

Private companies (as defined, see section 2.18) can choose to be exempt from applying the Variable Interest Model in common control arrangements that meet certain criteria. The FASB's goal was to allow private companies to simplify their accounting for these arrangements while continuing to give relevant information to users of private company financial statements.¹

ASU 2018-17, *Targeted Improvements to Related Party Guidance for Variable Interest Entities*, created a private company accounting alternative allowing private companies to make a policy election not to apply the Variable Interest Model to common control arrangements if certain criteria are met. This alternative eliminated the private company accounting alternative in ASU 2014-07, *Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*, which applied only to leasing arrangements between private companies under common control. In making this change, the FASB was responding to feedback that the cost and complexity of applying the VIE guidance could be further reduced by effectively expanding the private company accounting alternative in ASU 2014-07.² ASU 2018-17 also changed other criteria in ASU 2014-07.

To apply the private company accounting alternative, a reporting entity must elect a policy that is applied to all arrangements that meet the criteria. A reporting entity that elects the private company accounting alternative also must make certain disclosures about any qualifying arrangements and apply other consolidation guidance in ASC 810 (e.g., the Voting Model) as well as other applicable US GAAP (such as ASC 460 and ASC 840 or ASC 842) to the arrangements.

E.2 Scope (updated June 2023)

Excerpt from Accounting Standards Codification

Consolidation – Overall

Scope and Scope Exceptions – Variable Interest Entities

Accounting Alternative for Entities under Common Control

810-10-15-17AC

Paragraphs 810-10-15-17AD through 15-17AF, 810-10-50-2AG through 50-2AI, and 810-10-55-205AU through 55-205BF provide guidance for a **private company** electing the accounting alternative for entities under common control in this Subtopic.

810-10-15-17AD

A **legal entity** need not be evaluated by a private company (reporting entity) under the guidance in the Variable Interest Entities Subsections if all of the following criteria are met:

- a. The reporting entity and the legal entity are under common control.

¹ BC25 of ASU 2018-17.

² Paragraph BC20 of ASU 2018-17.

- b. The reporting entity and the legal entity are not under common control of a **public business entity**.
- c. The legal entity under common control is not a public business entity.
- d. The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity when considering the General Subsections of this Topic. The Variable Interest Entities Subsections shall not be applied when making this determination.

Applying this accounting alternative is an accounting policy election. If a private company elects to apply this accounting alternative, it shall apply this alternative to all legal entities if criteria (a) through (d) are met. A reporting entity that elects the accounting alternative and, thus, does not apply the guidance in the Variable Interest Entities Subsections shall continue to apply other accounting guidance (including guidance in the General Subsections of this Subtopic) unless another scope exception from this Topic applies...

810-10-15-17AF

If any of the criteria in paragraph 810-10-15-17AD for applying the accounting alternative cease to be met, a private company shall apply the guidance in the Variable Interest Entities Subsections at the date of change on a prospective basis, except for situations in which a reporting entity becomes a public business entity. When a reporting entity becomes a public business entity, it shall apply the guidance in the Variable Interest Entities Subsections in accordance with Topic 250 on accounting changes and error corrections.

Private companies can elect not to apply the Variable Interest Model to legal entities under common control if certain criteria are met. The private company accounting alternative *only* relieves the reporting entity from applying the Variable Interest Model to *certain* arrangements. It does not relieve it from consolidating entities under the Voting Model. Private companies are required to begin their consolidation analysis with the Variable Interest Model for legal entities that do not meet all of these criteria, unless another scope exception applies.

If a private company elects to apply the private company accounting alternative, it applies the alternative to **all** current and future arrangements that meet the criteria. Unless another scope exception to ASC 810 applies, an entity that elects the private company accounting alternative will apply the Voting Model or other applicable consolidation guidance (see section 11) to the legal entity. If consolidation is not required, the private company is required to make certain disclosures (see section E.5).

If elected, the private company accounting alternative would apply when all of the following criteria are met:

- ▶ The private company (reporting entity) and the legal entity being evaluated for consolidation are under common control under the Voting Model (see section E.3 for more guidance on assessing common control).
- ▶ The reporting entity, the legal entity and the common control parent are not PBEs (see sections 2.18 and 2.19 for more guidance on the definitions of a private company and a PBE, respectively).³ We believe this also includes intermediate parents of such entities. However, other entities consolidated by the common control parent may be PBEs without failing this criterion. See Illustration E-5 for an example.
- ▶ The reporting entity does not directly or indirectly control the legal entity under the General subsections of ASC 810 (e.g., the Voting Model).

³ ASC 810-10-15-17AD(b) and (c).

The last criterion states that the reporting entity cannot have a direct or indirect controlling financial interest in the legal entity being evaluated for consolidation when applying the Voting Model. This criterion prevents a reporting entity that is not the primary beneficiary from incorrectly consolidating under the Voting Model an entity that is a VIE. See Illustration E-4 for an example.

Companies that elect the private company accounting alternative and later become PBEs apply the Variable Interest Model to the arrangement retrospectively as an accounting change under ASC 250. Companies that no longer meet the criteria to apply the private company accounting alternative to an arrangement for any other reason (e.g., if the legal entity becomes a PBE) apply the Variable Interest Model to the legal entity prospectively.

See section E.4 for illustrations of how the guidance applies.

E.3 Evaluating common control (updated June 2023)

Excerpt from Accounting Standards Codification

Consolidation – Overall

Scope and Scope Exceptions – Variable Interest Entities

Accounting Alternative for Entities under Common Control

810-10-15-17AE

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

To apply the private company accounting alternative, the reporting entity must be under "common control" with the legal entity. This term is not defined in the Accounting Standards Codification; therefore, evaluating whether an entity could apply the private company accounting alternative may require significant judgment.

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).⁴ 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.

⁴ See section 2.3 of this publication and section C.2 of our FRD, *Business combinations*, for further interpretive guidance on evaluating common control.

- ▶ 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.

However, when applying the private company accounting alternative, the FASB stated in paragraphs BC18 through BC21 of ASU 2018-17 that it used the term more broadly than what is considered common control under 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.

Additionally, under ASU 2018-17, only the General subsections of ASC 810 (e.g., the Voting Model) are used to determine whether the private company (reporting entity) and legal entity are under common control. That is, the Variable Interest Model is not used to make the determination of common control when assessing whether an arrangement qualifies for the private company accounting alternative.

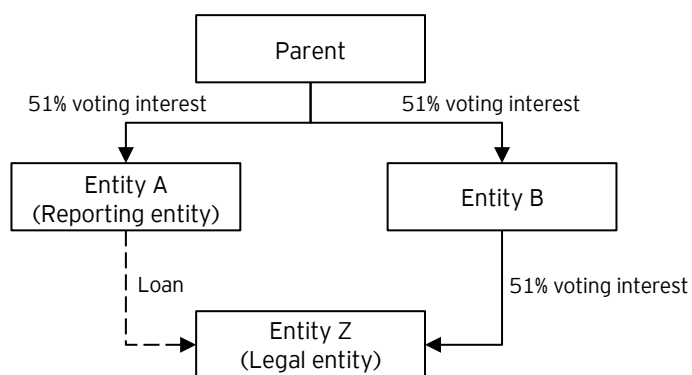
This differs from other aspects of US GAAP in which common control is evaluated under both the Variable Interest Model and the Voting Model, as applicable. The FASB added this clarification to provide relief for private companies from applying the Variable Interest Model to certain arrangements.⁵ See Illustration E-2 for an example.

E.4 Illustrations (updated June 2023)

The following illustrations, which are derived from ASC 810-10-55-205AU through 205BF, show how the private company accounting alternative guidance is applied. See ASC 810-10-55-205AU through 205BF for additional illustrations of the guidance.

Illustration E-1: Scope of the private company accounting alternative – all criteria met

Parent and Entities A (the reporting entity), B and Z (the legal entity being evaluated for consolidation) are all private companies as defined in US GAAP. Parent owns 51% of the voting shares of Entities A and B. Entity B owns 51% of the voting shares of Entity Z. The noncontrolling shareholders of Entities A, B and Z do not have substantive participating rights and no other facts or circumstances indicate that control does not rest with the majority owner. Entity A issued a loan to Entity Z (which would be a variable interest under the Variable Interest Model).



Entity A may apply the private company accounting alternative to Entity Z because the following criteria are met:

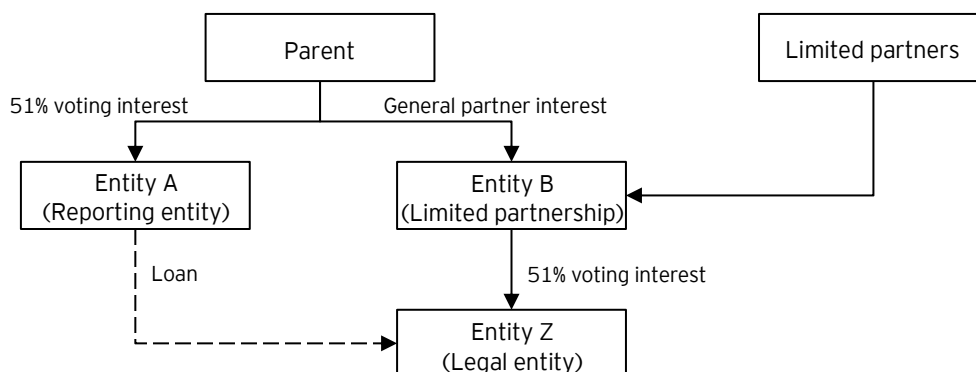
⁵ Paragraph BC21 of ASU 2018-17.

- ▶ **The reporting entity and the legal entity are under common control under the Voting Model** – Parent has a controlling financial interest under the Voting Model in Entities A and B because it holds a majority of their voting shares. Entity B has a controlling financial interest under the Voting Model in Entity Z because it holds a majority of its voting shares. Hence, Parent controls Entity Z through Entity B. Therefore, Entities A and Z are under common control under the Voting Model.
- ▶ **The reporting entity, the parent and the legal entity are not PBEs** – Parent and Entities A, B and Z are private companies.
- ▶ **The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity under the Voting Model** – Entity A does not directly or indirectly have a controlling financial interest in Entity Z under the Voting Model.

Under the private company accounting alternative, Entity A does not consolidate Entity Z under the Voting Model and makes the disclosures described in section E.5.

Illustration E-2: Scope of the private company accounting alternative – evaluation of common control

Parent and Entities A (the reporting entity), B (a limited partnership) and Z (the legal entity being evaluated for consolidation) are all private companies as defined in US GAAP. Parent owns 51% of the voting shares of Entity A. Parent is the general partner of Entity B and the limited partners do not have the ability to remove the general partner with a simple majority. Assume that Parent consolidates Entity B under the Variable Interest Model (i.e., it has power through its general partner interest and benefits). Entity B holds a majority of the voting shares of Entity Z. The noncontrolling shareholders of Entities A and Z do not have substantive participating rights and no other facts or circumstances indicate that control does not rest with the majority owner. Entity A issued a loan to Entity Z (which would be a variable interest under the Variable Interest Model).



Entity A may **not** apply the private company accounting alternative to Entity Z because all of the criteria are **not** met:

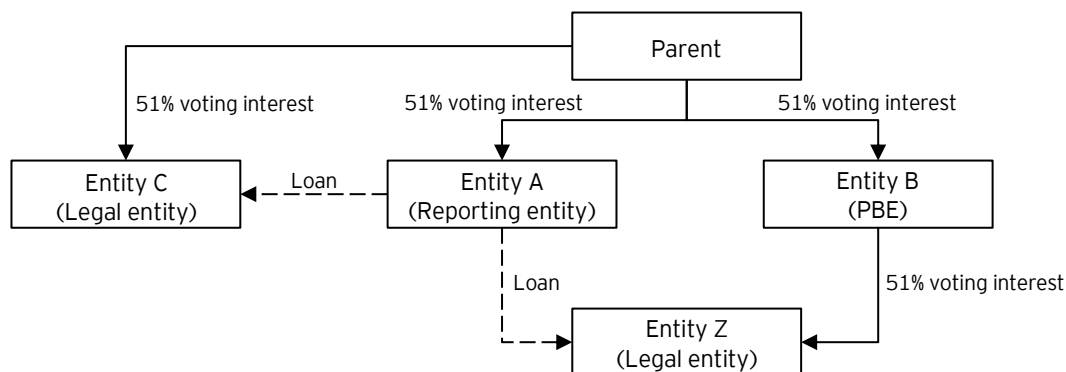
- ▶ **The reporting entity and the legal entity are under common control under the Voting Model** – Although Parent has a controlling financial interest under the Voting Model in Entity A, and Entity B has a controlling financial interest under the Voting Model in Entity Z, Parent has a controlling financial interest in Entity B under the Variable Interest Model (i.e., through its general partner interest). Parent does **not** have a controlling financial interest in Entity B under the Voting Model. Therefore, Entities A and Z are **not** under common control under the Voting Model.
- ▶ **The reporting entity, the parent and the legal entity are not PBEs** – Parent and Entities A, B and Z are private companies.

- ▶ **The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity under the Voting Model** – Entity A does not directly or indirectly have a controlling financial interest in Entity Z under the Voting Model.

Therefore, Entity A begins its evaluation of Entity Z under the Variable Interest Model.

Illustration E-3: Scope of the private company accounting alternative – evaluation of common control through a PBE

Parent and Entities A (the reporting entity), C and Z (legal entities being evaluated for consolidation) are all private companies as defined in US GAAP. Entity B is a PBE. Parent owns 51% of the voting shares of Entities A, B and C. Entity B owns 51% of the voting shares of Entity Z. The noncontrolling shareholders of Entities A, B, C and Z do not have substantive participating rights, and no other facts or circumstances indicate that control does not rest with the majority owner. Entity A issued loans to Entities C and Z (which would be a variable interest under the Variable Interest Model).



Entity A may apply the private company accounting alternative to Entity C but may **not** apply the private company accounting alternative to Entity Z based on the following evaluation:

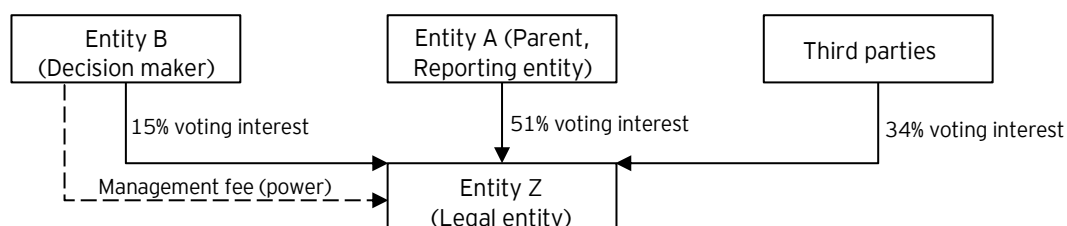
- ▶ **The reporting entity and the legal entity are under common control under the Voting Model** – Parent has a controlling financial interest under the Voting Model in Entities A, B and C because it holds a majority of their voting shares. Entity B has a controlling financial interest under the Voting Model in Entity Z because it holds a majority of its voting shares. Hence, Parent controls Entity Z through Entity B. Therefore, Entities A, B, C and Z are under common control of Parent under the Voting Model.
- ▶ **The reporting entity, the parent and the legal entity are not PBEs** – Although Parent and Entities A and Z are private companies, Entity B is a PBE. Because common control of Entity Z by Parent is through Entity B, which is a PBE, the private company accounting alternative cannot be applied to Entity Z. However, since Entity C is a private company, the private company accounting alternative can be applied to Entity C, even though other entities in the group are not eligible.
- ▶ **The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity under the Voting Model** – Entity A does not directly or indirectly have a controlling financial interest in Entities C or Z under the Voting Model.

Entity A would begin its evaluation of Entity Z under the Variable Interest Model.

Under the private company accounting alternative, Entity A does not consolidate Entity C under the Voting Model, and makes the disclosures described in section E.5.

Illustration E-4: Scope of the private company accounting alternative – evaluation of direct or indirect controlling financial interest under the Voting Model

Entities A (the reporting entity), B and Z (the legal entity being evaluated for consolidation) are all private companies. Entity A also has a controlling financial interest in Entity Z under the Voting Model because it holds a majority of the voting shares and the noncontrolling shareholders of Entity Z do not have substantive participating rights in the entity. Entity B is the decision maker for Entity Z and receives a management fee (which would be a variable interest under the Variable Interest Model due to its other interest in Entity Z).



Entity A may **not** elect the private company accounting alternative with respect to Entity Z because all of the criteria are **not** met:

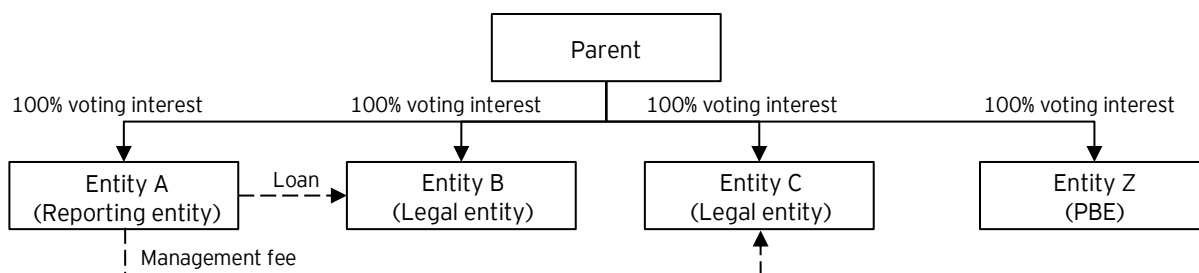
- ▶ **The reporting entity and the legal entity are under common control under the Voting Model** – Entity A has a controlling financial interest under the Voting Model in Entity Z because it holds a majority of its voting shares. Therefore, Entities A and Z are under common control under the Voting Model.
- ▶ **The reporting entity, the parent and the legal entity are not PBEs** – Entities A, B and Z are private companies.
- ▶ **The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity under the Voting Model** – Entity A does **not** meet this criterion because it has a direct controlling financial interest in Entity Z under the Voting Model, because it holds a majority of the voting rights. This example demonstrates the importance of this criterion because if Entity Z were a VIE and Entity A consolidated Entity Z without first evaluating Entity Z under the Variable Interest Model, it might incorrectly consolidate Entity Z.

Entity A begins its evaluation of Entity Z under the Variable Interest Model.

Illustration E-5: Scope of the private company accounting alternative – evaluation of all legal entities by a reporting entity

The following illustration was derived from Example 14 described in ASC 810-10-55-205BD through 205BE.

Entities A, B, C and Z are wholly owned subsidiaries of Parent. Parent and Entities A (the reporting entity), B (a legal entity being evaluated for consolidation) and C (a legal entity being evaluated for consolidation) are all private companies. Entity Z is a PBE. Entity A issued a loan to Entity B (which would be a variable interest under the Variable Interest Model). Entity A also is the decision maker for Entity C and receives a management fee from Entity C (assume that it would be a variable interest under the Variable Interest Model because it is not commensurate with the level of effort required to provide those services). No significant transactions or arrangements exist between Entity Z and the other wholly owned subsidiaries of Parent.



Evaluation of Entities B and C

Entity A may apply the private company accounting alternative to Entities B and C because all of the following criteria are met:

- ▶ **The reporting entity and the legal entity are under common control under the Voting Model –** Parent has a controlling financial interest under the Voting Model in Entities A, B and C because it owns 100% of the voting shares. Therefore, Entities A, B and C are under common control of Parent under the Voting Model.
- ▶ **The reporting entity, the parent and the legal entity are not PBEs –** Parent and Entities A, B and C are private companies. Even though Entity Z is a PBE, it does not affect the applicability of the private company accounting alternative for Entity A's assessment of Entities B and C.
- ▶ **The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity under the Voting Model –** Entity A does not directly or indirectly have a controlling financial interest in Entities B and C under the Voting Model.

If Entity A elects the private company accounting alternative, Entity A does not consolidate Entities B and C under the Voting Model but makes the disclosures described in section E.5 for both legal entities. Entity A must apply its accounting policy election to both entities consistently. That is, Entity A can elect to apply the private company accounting alternative to Entity B, but also must apply it to Entity C because all the criteria are met for both legal entities.

Evaluation of Entity Z

Regardless of the policy elected for Entities B and C, Entity A may **not** apply the private company accounting alternative to Entity Z because it is a PBE. Nonetheless, Entity A does not need to assess Entity Z for consolidation because it does not hold any interests in Entity Z.

E.5

Disclosures (updated June 2023)

Excerpt from Accounting Standards Codification**Consolidation – Overall***Scope and Scope Exceptions – Variable Interest Entities**Accounting Alternative for Entities under Common Control***810-10-15-17AD**

... A reporting entity applying this alternative shall disclose the required information specified in paragraphs 810-10-50-2AG through 50-2AI unless the legal entity is consolidated by the reporting entity through accounting guidance other than VIE guidance.

Consolidation – Overall*Disclosure – Variable Interest Entities**Accounting Alternative for Entities under Common Control***810-10-50-2AG**

A reporting entity that neither consolidates nor applies the requirements of the Variable Interest Entities Subsections to a **legal entity** under common control because it meets the criteria in paragraph 810-10-15-17AD shall disclose the following:

- a. The nature and risks associated with a reporting entity's involvement with the legal entity under common control.
- b. How a reporting entity's involvement with the legal entity under common control affects the reporting entity's financial position, financial performance, and cash flows.
- c. The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position resulting from its involvement with the legal entity under common control.
- d. The reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control. If the reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control cannot be quantified, that fact shall be disclosed.
- e. If the reporting entity's maximum exposure to loss (as required by (d)) exceeds the carrying amount of the assets and liabilities as described in (c), qualitative and quantitative information to allow users of financial statements to understand the excess exposure. That information shall include, but is not limited to, the terms of the arrangements, considering both explicit and implicit arrangements, that could require the reporting entity to provide financial support (for example, implicit guarantee to fund losses) to the legal entity under common control, including events or circumstances that could expose the reporting entity to a loss.

810-10-50-2AH

In applying the disclosure guidance in paragraph 810-10-50-2AG(d) through (e), a reporting entity under common control shall consider exposures through implicit guarantees. Determining whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:

- a. The **private company** (reporting entity) has an economic incentive to act as a guarantor or to make funds available.

- b. The private company (reporting entity) has acted as a guarantor for or made funds available to the legal entity in the past.

810-10-50-2A1

In disclosing information about the legal entity under common control, a private company (reporting entity) shall present these disclosures in addition to the disclosures required by other guidance (for example, in Topics 460 on guarantees, Topic 850 on related party disclosures, and Topic 842 on **leases**). Those disclosures could be combined in a single note or by including cross-references within the notes to financial statements.

To apply the private company accounting alternative, an entity elects an accounting policy for all current and future arrangements that meet the criteria in ASC 810-10-15-17AD. Assuming another scope exception does not apply, a reporting entity that elects the private company accounting alternative will proceed directly to the Voting Model or other applicable consolidation guidance.

When a reporting entity elects the private company accounting alternative and does not consolidate another legal entity, it is required to make the following disclosures:

- ▶ The nature and risks associated with a reporting entity's involvement with the legal entity
- ▶ How the reporting entity's involvement with the legal entity affects its financial position, financial performance and cash flows
- ▶ The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position resulting from its involvement with the legal entity
- ▶ The reporting entity's maximum exposure to loss resulting from its involvement with the legal entity or the fact that it cannot be quantified
- ▶ Qualitative and quantitative information describing the excess exposure if the reporting entity's maximum exposure to loss exceeds the carrying amount of the assets and liabilities

When making these disclosures, a private company must consider risks and exposures it has through implicit guarantees (i.e., guarantees that are implied rather than contractual) based on the relationship or past interactions between the private company and the legal entity. For example, an implicit guarantee might involve expectations that the private company would make funds available to the legal entity to prevent the parent's guarantee of the legal entity's debt from being called (or to the parent if it is required to perform on that guarantee, i.e., pay off the legal entity's debt). The existence of an implicit guarantee depends on facts and circumstances, including whether:

- ▶ The private company is economically incentivized to act as a guarantor or to make funds available.
- ▶ The private company made funds available in similar situations in the past.
- ▶ It would be a conflict of interest or illegal if the private company acts as a guarantor or makes funds available.

Private companies must present these disclosures in combination with other disclosures about the arrangement required by existing guidance (e.g., ASC 460, ASC 840, ASC 842, ASC 850) by either providing all of them in one place or by cross-referencing them in the notes to the financial statements. ASC 810-10-55-205BF provides an example of these disclosures.

F Affordable housing projects

F.1 Summary of the tax credit (updated June 2023)



FASB amendment

In March 2023, the FASB issued Accounting Standards Update (ASU) 2023-02, *Investments-Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*, allowing entities to apply the proportional amortization method to equity investments in all tax credit programs that meet the conditions in ASC 323-740-25-1, rather than just investments in qualified affordable housing projects that generate LIHTCs. Under the amended guidance, entities can elect the proportional amortization method on a tax-credit-program-by-tax-credit-program basis. If elected, the method should be applied consistently to all investments in the tax credit program. The ASU also made other changes to the guidance in ASC 323-740.

The guidance is effective for public business entities for fiscal years beginning after 15 December 2023, and interim periods within those fiscal years, and for all other entities for fiscal years beginning after 15 December 2024, and interim periods within those fiscal years. Early adoption is permitted for all entities in any interim period. See our Technical Line publication, [Expanded use of the proportional amortization method for equity investments in tax credit programs](#), for more discussion.

Excerpt from Accounting Standards Codification

Investments – Equity Method and Joint Ventures – Income Taxes

Overview and background

323-740-05-2

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.

Pending Content:

Transition Date: (P) December 16, 2023; (N) December 16, 2024 | **Transition Guidance:** 323-740-65-2

Paragraph superseded by Accounting Standards Update No. 2023-02.

323-740-05-3

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.

Pending Content:**Transition Date:** (P) December 16, 2023; (N) December 16, 2024 | **Transition Guidance:** 323-740-65-2

Paragraph superseded by Accounting Standards Update No. 2023-02.

F.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 the 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 section 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 D.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.

F.3 Primary beneficiary considerations (updated June 2023)

A reporting entity with a variable interest in a VIE is required to consolidate that VIE if it has both power and benefits (see section 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 section 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 exempt limited partners in tax credit partnerships that meet the conditions for applying the proportional amortization method from having to assess whether they benefit from “substantially all” of the entity’s activities (ASC 810-10-25-44B). As noted in paragraph BC72 of 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. The exemption has been limited to investors in LIHTC structures, but ASU 2023-02 broadened the scope of the proportional amortization guidance in ASC 323-740 to include equity investments in all tax credit programs that meet certain conditions. Therefore, the adoption of ASU 2023-02 could result in investors in other tax credit structures being exempt from the “substantially all” assessment.

Illustration F-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. The general partner made no guarantees to the limited partner. 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, is 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.

G Investment companies

G.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 (except as discussed in ASC 946-810-45-3) or the disclosure requirements of ASC 810.

G.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.
- d. It has ownership interests in the form of equity or partnership interests.
- e. It manages substantially all of its investments on a **fair value** basis.

946-10-15-8

To be an investment company, an entity shall possess the fundamental characteristics in paragraph 946-10-15-6. Typically, an investment company also has all of the characteristics in paragraph 946-10-15-7. However, the absence of one or more of those typical characteristics does not necessarily preclude an entity from being an investment company. If an entity does not possess one or more of the typical characteristics, it shall apply judgment and determine, considering all facts and circumstances, how its activities continue to be consistent (or are not consistent) with those of an investment company.

946-10-15-9

The implementation guidance in Section 946-10-55 is an integral part of assessing investment company status and provides additional guidance for that assessment.

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.

G.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 generally accounted for in accordance with ASC 946 and are not subject to consolidation or the disclosure requirements of ASC 810. ASC 946 generally requires investments in debt and equity securities to be subsequently measured at fair value.

An investment company may have an investment in an operating entity whose sole purpose is to provide services rather than to realize a gain on the sale of the investment, such as acting as an investment adviser or a transfer agent, to the investment company, rather than to third parties. When the investment company has a controlling financial interest in such an operating entity (as determined under ASC 810), the investment company consolidates the operating entity rather than measuring it at fair value. When the operating entity also provides services to third parties, the investment company should carefully evaluate the extent of the operating entity's services provided to the investment company relative to the third parties in reaching a conclusion. This evaluation may require significant judgment.

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. Other particular facts and circumstances may require combined financial statements, an equity method of accounting, or valuation allowances in order to achieve a fair presentation ...

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 and business development companies shall be prepared in accordance with §§210.3A-02 to 210.3A-03 (Article 3A) except that
 - (i) [Reserved]
 - (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 investment companies, for example, business development companies (BDCs) or registered investment companies (RICs), for their involvement in other investment companies, including substantially wholly owned investment companies.

Non-authoritative literature

US Securities and Exchange Commission, Division of Investment Management, Investment Management Guidance Update No. 2014-11

*BDCs with Wholly Owned Subsidiaries*¹³

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.¹⁵

¹³ Rule 1-02(aa) of Regulation S-X defines a wholly owned subsidiary as a subsidiary substantially all of whose outstanding voting shares are owned by its parent and/or the parent's other wholly owned subsidiaries.

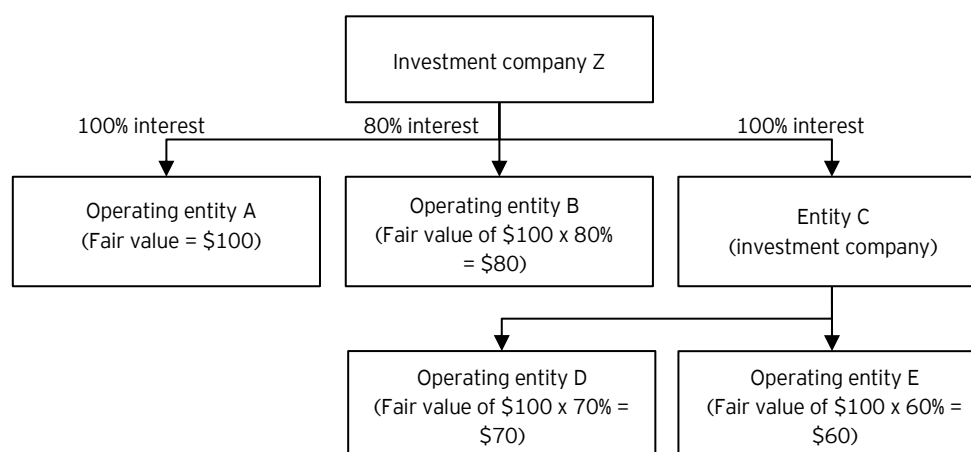
¹⁴ [Footnotes not shown]

¹⁵ In the staff's view, RICs in similar circumstances also should consolidate wholly owned subsidiaries (e.g., a RIC that uses a wholly owned subsidiary as a "blocker").

Illustration G-1: Accounting for investments by an investment company

Investment company Z holds 100% and 80% equity interests in Operating entity A and Operating entity B, respectively. Operating entities A and B do not provide services to Investment company Z. Investment company Z also holds 100% equity 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 acts as an extension of Investment company Z by facilitating the execution of Investment company Z's investment strategy. Investment company Z has decision-making ability for Operating entity A, Operating entity B and Entity C.

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

With respect to Operating entity A and Operating Entity B, because Investment company Z applies the guidance in ASC 946 and the exception in ASC 946-810-45-3 is not met, the scope exception from the consolidation guidance in ASC 810-10-15-12(d) applies.

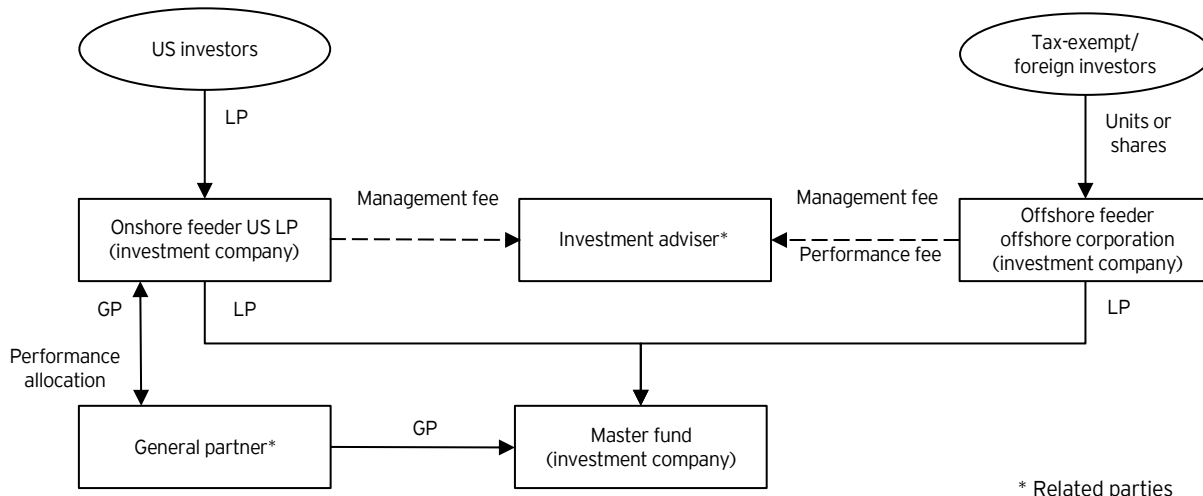
Investment company Z would not evaluate its equity investments in Operating entities A or B as potential variable interests that would require consolidation of those entities under the Variable Interest Model or Voting Model. Instead, Investment company Z would record each of its equity investments at 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.

ASC 946 is silent on whether an investment company should consolidate another investment company that it controls. Because Entity C is a holding company that is acting as an extension of Investment company Z and facilitates the execution of Investment company Z's investment strategy, Investment company Z has determined that it would consolidate Entity C and any other entities of this type. Investment company Z would recognize and measure Entity C's equity investments in Operating entities D and E at fair values of \$70 and \$60, respectively.

G.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



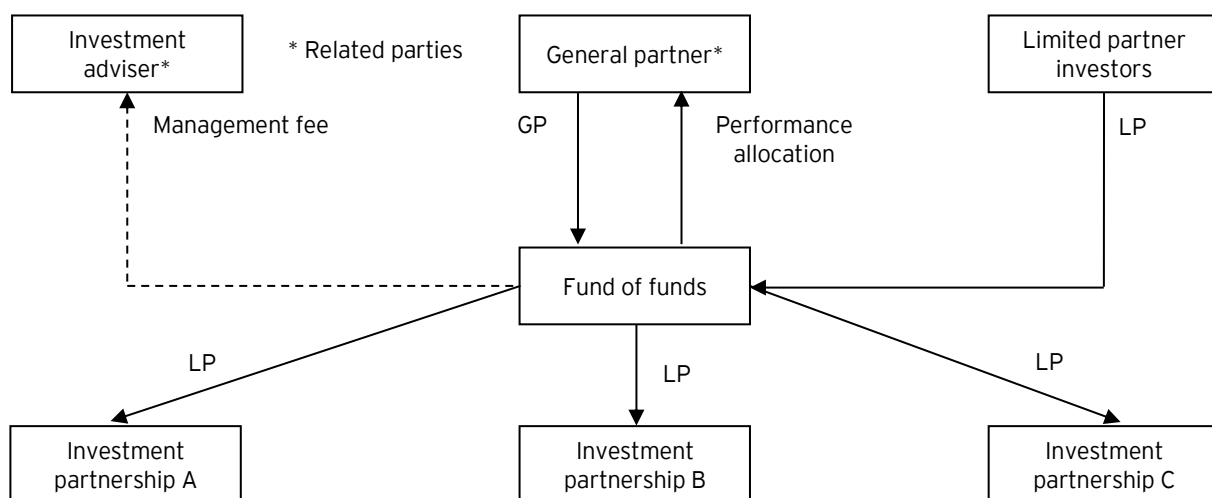
In a typical master/feeder structure, capital contributions are made by (1) US investors to an onshore feeder fund and (2) tax-exempt or foreign investors to an offshore feeder fund. The onshore feeder fund is typically an unregistered pooled investment company that is open to accredited US investors, 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 and have overall management and operations responsibilities. The general partner and/or investment adviser typically receives a management fee and a performance fee that are defined in a fund's governing documents (e.g., 2% management fee and a performance fee equivalent to 20% of profits). 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 an incentive allocation), 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.

G.2.1.1

SEC staff views on consolidation in master/feeder and fund of funds structures

Non-authoritative literature

US Securities and Exchange Commission, Division of Investment Management, Investment Management Guidance Update No. 2014-11

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,⁶ provided that, among other things: (i) the feeder fund attaches the financial statements of the master fund to its financial statements;⁷ (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.¹²

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.

G.3

Consolidation of investment companies

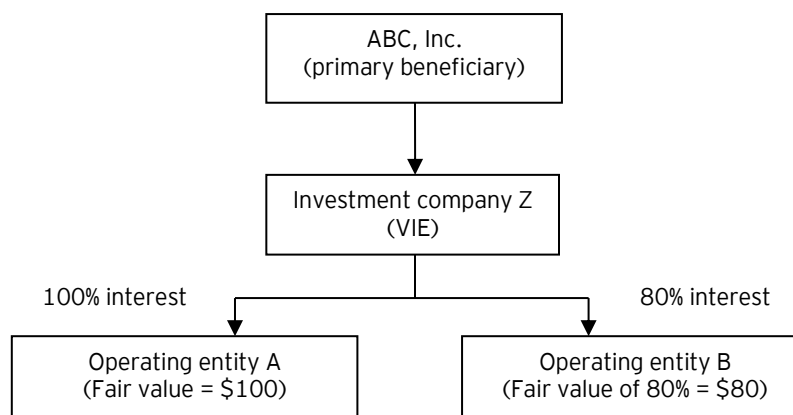
Excerpt from Accounting Standards Codification**Consolidation – Overall****Recognition – General****810-10-25-15**

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 in ASC 810-10-15-12(d) 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 ASC 810, 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 G-2: Accounting for investments in an investment company

Assume the same facts as in Illustration G-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.

**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, ABC, Inc. would attribute 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 G.2 for guidance when an investment company controls another investment company.

G.4 Combined financial statements under the Custody Rule

In March 2021, the SEC staff from the Division of Investment Management issued guidance on considerations that should inform a registered investment adviser's assessment of whether the adviser can distribute audited combined financial statements, instead of audited separate financial statements, to satisfy the adviser's obligations under Rule 206(4)-2(b)(4) under the Investment Advisers Act of 1940 (the Custody Rule).

Non-authoritative literature

US Securities and Exchange Commission, Division of Investment Management

Dear CFO Letter 2020-03, Combined Financial Statements for Compliance with Advisers Act Rule 206(4)-2

Rule 206(4)-2 [17 CFR § 275.206(4)-2] – *Custody of Funds or Securities of Clients by Investment Advisers* (the "Custody Rule") of the Investment Advisers Act of 1940 requires investment advisers who have custody of funds or securities of clients, among other things, to maintain the funds and securities in an account with a qualified custodian (as defined in the Custody Rule) in each client's name, or in an account in the adviser's name for the benefit of its clients. Paragraph (b)(4) of the Custody Rule ("audit exception") permits an adviser to comply with certain aspects¹ of the Custody Rule if an account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) (collectively, "PIVs") is subject to audit (as defined in rule 1-02(d) of Regulation S-X (17 CFR 210.1-02(d)).

An investment adviser may wish to obtain audits of financial statements for multiple PIVs on a combined basis for operational purposes. ASC 810-10-55-1B states, in part, that "[t]here are circumstances, however, in which combined financial statements (as distinguished from consolidated financial statements) of commonly controlled entities are likely to be more meaningful than their separate financial statements. For example, combined financial statements would be useful if one individual owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be used to present the financial position and results of operations of entities under common management."

For purposes of compliance with the audit exception, we do not believe that an investment adviser can prepare combined financial statements for multiple PIVs in reliance solely on the common management basis in ASC 810-10-55-1B. An investment adviser should consider what presentation would be more meaningful to an investor. This may include considering whether a combined presentation would be more meaningful than a stand-alone presentation and whether an individual investor could reasonably interpret the information presented on a combined basis to the investor's ownership in a specific PIV.

The staff believes that an investment adviser assessing whether to use combined financial statements for purposes of satisfying the audit exception to the Custody Rule generally should consider, among other things, how each of the following may impact a more meaningful presentation:

- ▶ The management of each PIV;
- ▶ The legal ownership of each investment individually with each PIV or if contractual agreements which show the assignment of investments held on a combined basis to each PIV exist;
- ▶ How investment gains and losses, including income and expenses, are allocated to each PIV;
- ▶ The management fee and performance fee structure of each PIV (e.g., if allocations work on a combined basis, calculated based on one hurdle on the combined basis, including combined fair values and contributions/distributions); and
- ▶ The investor base and investor rights over the life of each PIV.

Combined financial statements must be presented in accordance with U.S. GAAP. This includes adequate disclosure when individual investor financial highlights differ from those presented in the combined financial highlights.² Presentation in accordance with U.S. GAAP also includes adequate disclosure of the ratio of total contributed capital to total committed capital,³ where applicable. A registered investment adviser may also consider incremental disclosures, such as presenting a statement of changes and financial highlights for each PIV separately.

It is the Commission's belief, expressed in the release adopting revisions to the Custody Rule, that financial statement audits provide meaningful protections to investors.⁴ The SEC staff encourages investment advisers and their auditors to consult with the staff if their fact patterns raise additional concerns or questions about the ability to utilize audits of financial statements for multiples PIVs on a combined basis for purposes of satisfying the Custody Rule.

¹ Paragraph (b)(4) notes that PIVs subject to the audit exception are not required to comply with paragraph (a)(2) and (a)(3) and such PIVs shall be deemed to have complied with paragraph (a)(4).

² If ratios are calculated for each common class taken as a whole, the financial statements shall disclose that an individual investor's ratio may vary from those ratios. See ASC 946-205-50-15.

³ PIVs that "obtain capital commitments from investors and periodically call capital under those commitments to make investments (principally limited-life, nonregistered investment partnerships) shall disclose in the financial highlights or in a note to the financial statements the total committed capital of the partnership (including general partner), the year of formation of the entity, and the ratio of total contributed capital to total committed capital," ASC 946-205-50-25.

⁴ See Investment Advisers Act Release No. 2968 (Dec. 30, 2009) [75 FR 1456 (Jan. 11, 2010)].

H Lot option contracts

H.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 that 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. However, the purpose and design of each structure must be understood before applying ASC 810. This appendix does not analyze the provisions of ASC 840, ASC 842 and ASC 470-40, which also may need to be evaluated when a homebuilder concludes that it is not required to consolidate the landowning entity under the Variable Interest Model.

H.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 landowner may contribute the land to the LLC or enter into a series of contracts to acquire and develop land after the LLC is formed. Lot option contracts are generally structured so that in exchange for a deposit,¹ the homebuilder has the option to purchase raw land or developed land from the LLC at a future date. Depending on the terms of the lot option contract, the purchase price could be fixed or could be fair value.

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. Depending on the purpose and design of the LLC, the land subject to the purchase option may be the only asset in the LLC, or there may be other land and assets owned by the LLC. 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 as discussed in sections H.4.2.2 and 7.3.2, 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.

H.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 fixed price 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.

H.3.1 Variable interests in specified assets

If a variable interest holder has an interest in a specified asset in a VIE, the interest is considered a variable interest in the VIE only if the fair value of the specified asset 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 to no variability). 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 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.

H.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 (see sections 5.1 and 5.2 for more guidance on determining the variability that entity was designed to create and distribute when identifying 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 Variable Interest Model further.

H.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 (see section 7.2).
- ▶ As a group, the equity owners either (1) lack the power (through voting rights or similar rights) to direct the activities that most significantly impact 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 (see section 7.3).
- ▶ The LLC is established with non-substantive voting rights (i.e., an anti-abuse clause) (see section 7.4).

H.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 GAAP financial statements may be considered at risk equity. Sufficiency of equity at risk 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. See section 7.2.3 for additional guidance on these methods.

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 is considered investment grade and 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 if there are multiple classes of debt, additional evidence and professional judgment will be required to evaluate whether the equity investment at risk is sufficient to permit the LLC to finance its activities without additional subordinated financial support.²

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.

H.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:

- ▶ 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

H.4.2.1 **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 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 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 for any revenue-generating activities on the land subject to the lot option contract, development of the land owned by the LLC). 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 holders of the equity investments at risk in a typical LLC structure will generally have the power to direct the activities that most significantly impact 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. See section 7.3.1 for additional considerations related to this criterion.

H.4.2.2 **Obligation to absorb an 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, a nonrefundable deposit from the homebuilder protects the single member of the LLC from first dollar risk of loss; therefore, the LLC generally will not meet this criterion and will be a VIE. If the deposit is refundable, the single member of the LLC likely absorbs the entity's losses through its equity at risk and the LLC likely is not a VIE under this criterion.

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. See section 7.3.2 for additional considerations related to this criterion.

H.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. See section 7.3.3 for additional guidance related to this criterion.

H.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 meet this condition.

H.5 Determining whether the homebuilder is the primary beneficiary

When the homebuilder concludes that the LLC is a VIE as discussed in section H.4, the homebuilder must evaluate whether it is the primary beneficiary of the LLC and therefore 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 (see section 8). Additional considerations exist if the option holder and single member of the LLC are related parties or de facto agents, as discussed in section 9.

³ This analysis assumes that the lot option holder and single member of the LLC are not related parties or de facto agents as defined in ASC 810. See section 10 for additional guidance.

H.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 impact 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." 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 (as discussed in sections 7.3.1.2 and H.4.2.1).

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.

H.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.

H.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 terms as of that date. Each subsequent substantive 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. In addition, other events may occur that would require reconsideration of whether the LLC is a VIE, as discussed in section 12.1.

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 under the original contract 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 homebuilder would consider whether it still has a variable interest based on facts and circumstances, as discussed in section H.3.1. See section 12 for additional examples and discussion of reconsideration events.

H.7 Recognition and measurement

If a homebuilder is determined to be the primary beneficiary of an LLC that is a VIE, it generally should initially measure the assets, liabilities and noncontrolling interests of the newly consolidated LLC at fair value at the date the reporting entity first becomes the primary beneficiary, as discussed in section 13. 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. 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, as discussed in section 23.1.

H.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 an LLC, it may be required to provide disclosures specified in the Variable Interest Model, as discussed in section 23.2.

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