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Consolidation

Partially updated December 2023

About the Consolidation guide

PwC is pleased to offer our *Consolidation* guide. This guide begins with a summary of the overall consolidation framework. The ensuing chapters discuss the variable interest entity and the voting interest entity models. In addition, this guide discusses the accounting for intercompany transactions in consolidation and other related matters.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the Financial Accounting Standards Board's *Accounting Standards Codification* are clearly designated, either within quotes in the regular text or enclosed within a shaded box. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations are:

- *Bankruptcies and liquidations (BLG)*
- *Business combinations and noncontrolling interests (BCG)*
- *Derivative instruments and hedging activities (DH)*
- *Equity method investments and joint ventures (EM)*
- *Fair value measurements (FV)*
- *Financial statement presentation (FSP)*
- *Financing transactions (FG)*
- *Income taxes (TX)*

- *Not-for-profit entities (NP)*
- *Stock-based compensation (SC)*
- *Transfers and servicing of financial assets (TS)*
- *Utilities and power companies (UP)*

Summary of significant changes

Following is a summary of the noteworthy revisions to the guide since it was last updated. Additional updates may be made to keep pace with significant developments.

Revisions made in September 2023

CG 1, Background on the consolidation framework

- Section 1.1.3 was updated to reflect the guidance in ASU 2023-05, *Business Combinations—Joint Venture Formations*, on the accounting by a joint venture entity for contributions received upon formation.

CG 4, Determining whether an entity is a VIE

- Section 4.3 was updated to reflect the guidance in ASU 2023-05 on accounting by a joint venture entity for contributions received upon formation.

CG 8, Intercompany transactions, proportionate consolidation, and other matters

- Section 8.3 was updated to reflect the issuance of ASU 2023-05, which is effective for joint venture entities formed on or after January 1, 2025.

Revisions made in January 2023

CG 5, Identifying the primary beneficiary of a VIE

- Figure CG 5-1 was added to **CG 5.1** to provide a general overview of the primary beneficiary analysis from the reporting entity's perspective (excluding related party considerations).
- **CG 5.2.11** was updated to include an example of when a variable interest holder may lack stated power while holding an economic interest in a VIE that exposes the variable interest holder to greater than a majority of the VIE's benefits and losses, and how that may impact the primary beneficiary analysis.
- Figure CG 5-2 was added to **CG 5.7** to provide a general overview of the primary beneficiary analysis including related parties.
- **CG 5.6.4** was added to discuss the primary beneficiary analysis when there are multiple decision makers in a related party group.

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***Chapter 1:
The consolidation
framework—updated
December 2023***

1.1 Background on the consolidation framework

Determining when one entity should consolidate another can be complex. However, it is important to investors because when one entity consolidates another, it reports the other entity's assets, liabilities, revenues, and expenses together with its own, as if they are a single economic unit. Consequently, the consolidation decision can have a significant impact on the consolidating entity's results of operations, cash flows, reported leverage, and other metrics.

In accounting, control is required for one entity to consolidate another. Control, as it is described in ASC 810, is the foundation for the consolidation model.

1.1.1 Evolution of two consolidation models

The original US consolidation standard, issued in the 1950s, was based on the notion that control was generally demonstrated by holding a majority of the voting rights of an entity. This consolidation model, which is still used today, is commonly referred to as the voting interest entity (VOE) model.

Later, a separate model, within the broader voting interest entity model, was developed for limited partnerships and similar entities. That model included the presumption that the general partner controlled a partnership unless the limited partners were able to remove the general partner by a simple majority vote.

The use of securitizations, a process to bundle financial assets into securities, increased during the 1990s and 2000s, as did the use of highly-structured entities, commonly referred to as "special purpose entities," which were not consolidated under the accounting guidance as it existed at the time. Some high-profile perceived abuses of the consolidation rules in the early 2000s resulted in the introduction of the "risks and rewards consolidation model." This model is referred to as the variable interest entity (VIE) model.

The original VIE model provided that if an entity expected to assume more than 50% of another entity's expected losses or gains, it should consolidate that entity. This model created a "bright line," and allowed entities to structure transactions to achieve a specific consolidation objective—either to consolidate another entity or not. Additional revisions and further guidance were issued subsequently to address some of the implementation questions that arose with this risk and rewards approach to the VIE model.

The financial crisis that began in 2008 provided another catalyst for change as some financial institutions were exposed to losses related to entities that were not consolidated under the VIE model (i.e., off-balance sheet entities). Stakeholders called for greater transparency into these entities, and in response, the model for assessing control for variable interest entities changed from one focused exclusively on risks and rewards to one focused on having both the power to direct an entity's key activities and exposure to potentially significant gains and losses (a "power and economics" model).

Subsequently, the VIE model was amended several times to address concerns of asset managers, provide relief for private companies in certain circumstances (a private company accounting alternative), alter how a decision maker considers its fees earned and its indirect interests in a VIE held through an entity under common control, eliminate the exception for certain development stage entities from being considered variable interest entities, and provide a measurement alternative for consolidated collateralized financing entities.

The VOE model was also amended to remove the presumption that a general partner controls a partnership unless the limited partners are able to remove the general partner by a simple majority vote.

See CG 3 to CG 6 for details on the VIE consolidation model and CG 7 for details on the VOE consolidation model.

1.1.2 Equity method of accounting or other applicable guidance

If a reporting entity determines it does not meet the criteria to consolidate a legal entity, it should next determine if the equity method of accounting is appropriate. The equity method of accounting is an approach for an investor to measure investments in common stock or other eligible investments in an investee entity (i.e., investments considered to be “in-substance” common stock, such as certain preferred stock investments) by recognizing its share of the net assets underlying those investments. It also requires the investor to recognize, in net income, its share of the investee’s earnings for each reporting period. The equity method of accounting is required when an investor or a company is able to exercise significant influence over the operating or financial decisions of an investee.

The equity method of accounting guidance also addresses many other items, including:

- An investor’s accounting for subsequent investments in an investee after suspending equity method loss recognition
- Stock-based compensation granted by an investor to employees of the investee, exchanges of equity method investments
- The determination of when limited partnerships and limited liability companies should be subject to the equity method
- The receipt of an equity method investment for the contribution of nonfinancial assets

See EM for details on the equity method of accounting.

Only after a reporting entity has determined that its financial relationship with an entity does not give rise to a controlling financial interest or an equity method investment, would it look to other accounting guidance to determine the appropriate accounting for that relationship. Other guidance that may be applicable includes the accounting for receivables (ASC 310), debt securities (ASC 320), equity securities (ASC 321), other investments (ASC 325), contingencies (ASC 450), guarantees (ASC 460), collaborative arrangements (ASC 808), derivatives (ASC 815), and other industry-specific guidance.

1.1.3 Joint venture accounting

Historically, the equity method was commonly applied to investments in joint ventures. The subsequent introduction of the VIE risks and rewards model led to some entities no longer being viewed as joint ventures and instead needing to be consolidated by one of the venturers.

Today, the starting point for assessing an investment, including one in a potential joint venture, is the consolidation guidance. An investor in an entity needs to first determine if it has a controlling financial

interest and, if so, would need to consolidate the venture. Only those entities that are not required to be consolidated by any of the investors can meet the accounting definition of a joint venture.

Some nuances have evolved in practice in the accounting for investments in joint ventures under the equity method and the accounting by the joint venture entity. These differences arise predominantly in the accounting for non-cash contributions to the joint venture prior to the adoption of ASU 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*. After adoption of ASU 2023-05, the joint venture is required to account for all contributions received upon formation by applying a new basis of accounting, which may eliminate some of the differences in accounting between the investor and investee. See EM 6 for further discussion on the accounting by joint ventures and for investments in joint ventures.

Proportionate consolidation is used in limited circumstances in the extractive and construction industries as an alternative to the equity method. See CG 8.4 for further discussion on proportionate consolidation.

1.2 The consolidation framework

This section provides a summary of the consolidation accounting framework. It also addresses matters that are a precondition to assessing an entity for consolidation, in particular, how to determine if there is a legal entity and when a legal entity is scoped out of the consolidation assessment. Detailed application of the VIE and VOE consolidation models are addressed in subsequent chapters of this guide.

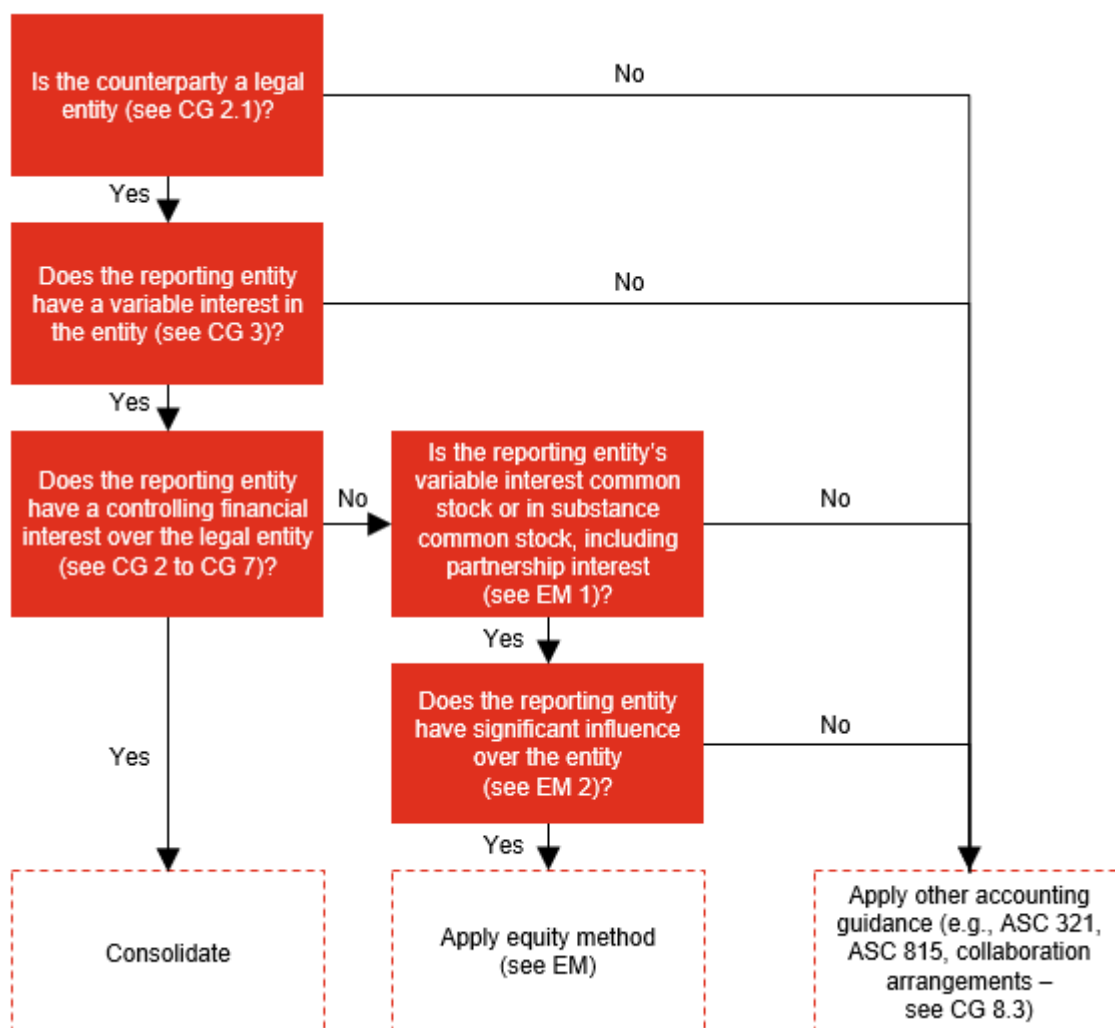
1.2.1 Overview of the consolidation framework

A reporting entity that has a financial relationship with a legal entity should evaluate whether the legal entity should be consolidated or whether it should be accounted for under other guidance, such as the equity method of accounting. In the context of consolidation, a reporting entity must have a “variable interest” in the other entity to assess whether consolidation is required. Broadly defined, a variable interest is a financial relationship that exposes the reporting entity to the risks and/or rewards of (variability in) the entity’s assets and operations. See CG 3 for further discussion of what constitutes a variable interest.

Although an equity investment is the most common form of variable interest through which an investor can obtain a controlling financial interest, many other relationships can also provide control over an entity. For example, a reporting entity that provides financing or credit support, such as a lender, lessor, or guarantor, also has a financial relationship with the entity and is generally exposed to the risk of the entity’s assets and operations. These types of arrangements may establish a controlling financial interest over the entity if they convey power to the holder of the variable interest.

Scope exceptions that may exempt a reporting entity from assessing consolidation are discussed in CG 1.2.3. Figure CG 1-1 provides an overview of the consolidation evaluation for reporting entities.

Figure CG 1-1
Summary decision tree



1.2.2 Consolidation background and general considerations

Absent a scope exception, any legal entity—regardless of its legal form and the scope of its activities—may be subject to consolidation. The ASC Master Glossary provides the following definition of a legal entity.

Definition from ASC 810-10-20

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

As discussed in CG 2.1, the definition of legal entity is expansive. The term is intended to encompass all legal structures established to manage or administer activities of any kind, or to hold assets or incur liabilities. CG 2.1.1 cites various factors that may be relevant when evaluating whether a particular structure is, in fact, a legal entity.

1.2.3 Exceptions to consolidation

Investors and other variable interest holders in certain specified legal entities (e.g., employee benefit plans sponsored by employers) are exempt from evaluating those entities for consolidation under any consolidation model. In addition, certain legal entities are exempt from evaluating investees in which they hold a variable interest for consolidation under any consolidation model (e.g., investment companies). Exceptions were provided principally because consolidation of these entities would not provide the most relevant information to investors about the assets, liabilities, and operations of the reporting entity. Scope exceptions include the following legal entities:

- Employers' interests in employee benefit plans (see CG 2.2.1)
- Investment companies (see CG 2.2.2)
- Governmental organizations (see CG 2.2.3)
- Money market funds (see CG 2.2.4)

Care should be taken to understand which reporting entity is subject to an exception. These exceptions are discussed in CG 2.2.1 to CG 2.2.4.

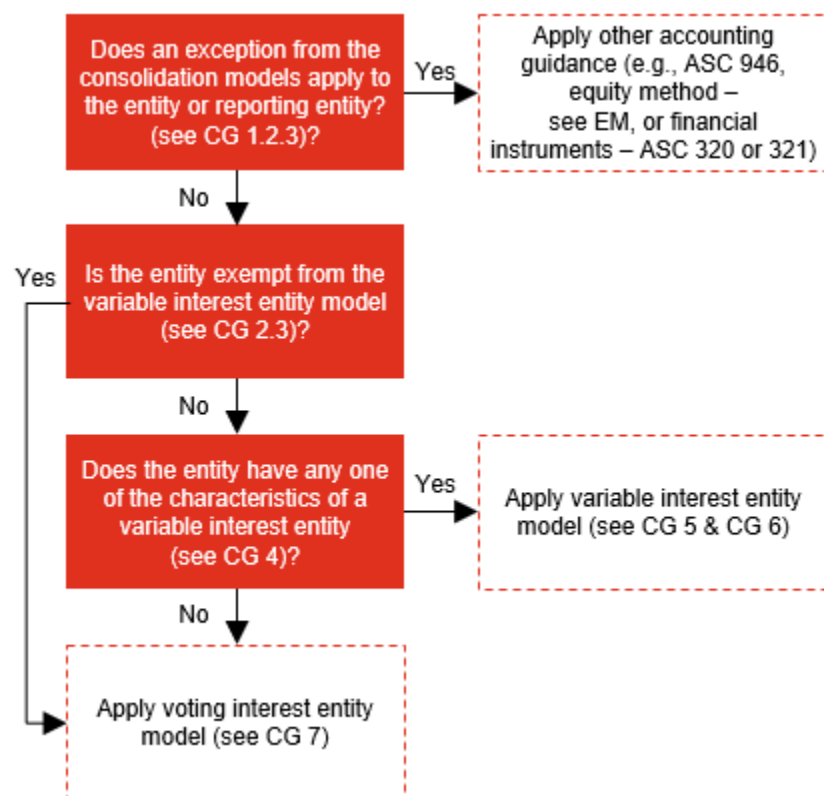
1.3 The consolidation models

There are two primary consolidation models in US GAAP – the variable interest entity (VIE) and voting interest entity (VOE) models.

A reporting entity that has a variable interest in a legal entity not subject to a scope exception would need to first determine whether the VIE model applies. Only if the entity is determined to not be a VIE would the VOE model be applied.

Figure CG 1-2 illustrates the general framework to be applied once a variable interest in a legal entity has been identified.

Figure CG 1-2
Consolidation framework decision tree



1.3.1 *The variable interest entity model*

Prior to applying the VIE model for consolidation of a legal entity, the reporting entity must first assess whether the legal entity qualifies for a scope exception (see CG 1.3.1.1) and whether it meets any of the five characteristics of a variable interest entity (see CG 1.3.1.2). If the legal entity does not qualify for a VIE scope exception and meets one of the five characteristics of a variable interest entity, the reporting entity should evaluate whether it is the primary beneficiary of the variable interest entity (see CG 1.3.1.3).

1.3.1.1 *Exceptions to the variable interest entity model*

Some legal entities may be subject to evaluation under the consolidation guidance but are exempt from being evaluated for consolidation under the VIE model (e.g., not-for-profit entities as discussed in NP 5.2). In these circumstances, the entity would need to be evaluated for consolidation under the voting interest model. See CG 2.3 for these scope exceptions.

1.3.1.2 *The five characteristics of a variable interest entity*

There are five principal reasons that an entity would be deemed to be a VIE. These are commonly referred to as the characteristics of a VIE. If any one of these is present, then the entity needs to be evaluated for consolidation under the VIE model.

The characteristics aim to capture those situations where it would be inappropriate to look to only voting rights for determining whether a reporting entity has a controlling financial interest. The first characteristic acknowledges that when an entity is insufficiently capitalized, it may be the debt holders or other variable interest holders who have control. The second characteristic identifies those situations where the equity holders do not have power over the activities of the entity that matter (nonsubstantive voting). The third characteristic identifies situations where the voting rights of the equity holders are not proportionate to their economic interests. The final two characteristics capture those situations where the equity holders are not exposed to the residual losses or benefits that one would normally associate with equity investors.

The VIE model typically applies to entities that are formed for a predefined limited purpose, such as securitizations and asset-backed financing entities because these entities normally meet the definition of a VIE. However, the VIE model may also apply to operating companies and joint ventures. For example, contractual arrangements may be used to convey control over an operating entity when equity ownership is precluded for legal or regulatory reasons or equity holders may not be fully exposed to the entity's benefits or losses due to a cost plus or guarantee arrangement.

See CG 4 for a detailed discussion of each of the characteristics.

1.3.1.3 Primary beneficiary of a variable interest entity

Within the VIE model, the party that is determined to have a controlling financial interest is referred to as the primary beneficiary. The primary beneficiary is defined as being the party that meets both of the following criteria:

- Power to direct the activities of the entity that most significantly impact the entity's economic performance (the power criterion)
- The obligation to absorb losses of the entity, or the right to receive benefits of the entity, which could be potentially significant to the entity (the economics criterion)

The primary beneficiary analysis requires the exercise of judgment. Depending on the entity being assessed, one of the criteria may require more analysis than the other. For example, in a joint venture, it is often clear that the venturers all have significant economic interests in the entity and therefore determining the primary beneficiary hinges on which party has power. In contrast, in an entity that holds only financial assets, such as a securitization vehicle, it may be clear that a servicer has decision making power and therefore determining the primary beneficiary will hinge on whether the servicer has a potentially significant economic exposure to the entity.

The level of economic exposure needed to be a primary beneficiary is well below that of a majority. This is in sharp contrast to the voting interest entity model where, since voting rights and economic interests are usually aligned, consolidation typically is not required when a reporting entity is not exposed to a majority of the economics of an entity. The assessment of what is a potentially significant economic exposure is not solely a quantitative assessment. See CG 5 for detailed discussion on the primary beneficiary assessment under the VIE model.

The VIE model specifies how to consider related parties. Related parties can have a significant impact on the ultimate consolidation conclusion. The related party guidance in the VIE model is applied differently when there is a single party with decision making power versus when power is shared between two or more parties. Even when a reporting entity is not the primary beneficiary on a

standalone basis, it may still need to consolidate the entity if its related party group has control, and it is deemed to be the party that is most closely associated with the entity. This concept is referred to as the related party tiebreaker. See CG 5.6 to CG 5.8 for a detailed discussion on the related party and related party tiebreaker considerations under the VIE model.

1.3.2 *The voting interest entity model*

A reporting entity that has a variable interest in a legal entity may need to assess that legal entity for consolidation under the voting interest entity model. The VOE model would apply either because (1) the legal entity does not have one of the five characteristics of a VIE (see CG 1.3.1.2), or (2) the entity or reporting entity is subject to a scope exception from the VIE model (see CG 2.3). A consolidation evaluation is only required under one of the models. The voting interest model should not be applied in instances where the investor determines it has a variable interest in a VIE but is not required to consolidate the VIE.

Under the VOE model, for legal entities other than partnerships, the usual condition for control is ownership, directly or indirectly, of more than 50% of the outstanding voting shares over an entity. For limited partnerships and similar entities, the usual condition for control is ownership, directly or indirectly, of more than 50% of a limited partnership's kick-out rights. However, substantive participating rights held by the noncontrolling interest holders would preclude the holder of the majority voting or kick-out rights from having a controlling financial interest. Substantive participating rights are those rights that enable the holder to block or participate in certain significant financial and operating decisions of the entity that are made in the ordinary course of business.

There are also other situations where a holder of the majority voting rights may not have a controlling financial interest. For example, this could occur when an entity files for bankruptcy or otherwise becomes subject to the control of a government, court, administrator, or regulator. See BLG 3.18 for a discussion of consolidation considerations when an entity files for bankruptcy.

See CG 7 for a detailed discussion on the voting interest entity model.

1.3.2.1 *Control by contract (consolidation)*

Within the VOE model, there is guidance to accommodate entities that may be controlled through a contractual arrangement. This "control by contract" was initially developed specifically for physician practice management structures at a time when the VIE model did not exist, but the model is not limited in scope to physician practice management structures. Today, most physician practice management structures and other entities controlled through a contractual arrangement fall within the VIE model. Consequently, few structures seen today fall within the control by contract guidance under the VOE model. See CG 7.4 for a detailed discussion on the control by contract voting model.

1.3.3 *Comparison of the variable and voting interest entity models*

Figure CG 1-3 summarizes some of the more notable differences between the two consolidation models.

Figure CG 1-3

Key differences between the variable interest entity and voting interest entity models

Area	Voting interest entity model	Variable interest entity model
Definition of control (controlling financial interest)	<p>For legal entities other than partnerships, the usual condition for control is ownership, directly or indirectly, of more than 50% of the outstanding voting shares over an entity.</p> <p>For limited partnerships and similar entities, the usual condition for control is ownership, directly or indirectly, of more than 50% of a limited partnership's kick-out rights (i.e., having the ability to replace the general partner or to liquidate the entity).</p>	<p>A party has control if it has both:</p> <ul style="list-style-type: none"> □ Power to direct the activities of the entity that most significantly impact the entity's economic performance, and □ The obligation to absorb losses of the entity, or the right to receive benefits of the entity, which could be potentially significant to the entity.
Related party considerations	No specific guidance	<p>Interests held by related parties have the potential to impact a number of areas, including whether:</p> <ul style="list-style-type: none"> □ A decision maker has a variable interest (assessing whether other economic interests held by the decision maker are more than insignificant) □ An entity is a VIE (as discussed in CG 4.5, characteristic 3) □ A single decision maker is the primary beneficiary on a standalone basis (the indirect interest concept) □ The related party tiebreaker needs to be applied □ A non-decision maker is the primary beneficiary within a related party group with a single decision maker (the substantially all concept)

Area	Voting interest entity model	Variable interest entity model
Participating rights	<p>Defined as rights to block or participate in certain significant financial and operating decisions of the entity that are made in the ordinary course of business</p> <p>Substantive participating rights over a significant activity (e.g., budgets) held by a noncontrolling investor preclude the majority shareholder from consolidating</p> <p>The voting interest definition of participating rights is applied for determining if a limited partnership is a VIE</p>	<p>Defined as rights to block or participate in actions through which power to direct the activities that most significantly impact the entity's performance are exercised</p> <p>To be substantive and preclude the party with decision making power from consolidating, the participating rights must enable the holder to participate in all significant activities, and must be unilaterally exercisable by a single party</p>
Disclosures	<p>Limited required disclosures for consolidated subsidiaries that are voting entities; however, consideration is given to disclosures on key judgments (see FSP 18.5)</p>	<p>Incremental disclosures are required for reporting entities that are the primary beneficiary and also for other reporting entities that hold variable interests in a VIE. In addition, incremental disclosures about support arrangements and financial support provided to money market funds are required (see FSP 18.4 for further discussion on the disclosures)</p>

1.4 Accounting for a consolidated entity

This section addresses practical application issues after a reporting entity concludes that consolidation of a legal entity is required. After determining that consolidation is required, a reporting entity should consider the initial consolidation of the entity (see CG 1.4.1), the requirement to reassess its previous consolidation conclusions (see CG 1.4.2), the impact of changes in interest transactions (see CG 1.4.2), intercompany transactions and related eliminations in consolidation (see CG 1.4.3), and the allocation of comprehensive income to controlling and noncontrolling interests (see CG 1.4.4).

1.4.1 Initial consolidation

When a reporting entity obtains control of a legal entity, it must determine if the net assets within the legal entity constitute a business. To the extent it is a business, acquisition accounting procedures under ASC 805 would be applied irrespective of whether control is gained under the VIE or voting interest entity model. Therefore, the initial consolidation of a VIE that is a business and not received in

a common control transaction is treated as a business combination. See BCG 1.2 for the definition of a business and BCG 2 for application of the acquisition method when acquiring a business.

If a reporting entity obtained control of a VOE legal entity that is not a business and not a common control transfer, then it is accounted for as an asset acquisition. See PPE 2 for details on the accounting for acquisitions that do not constitute a business. However, if the legal entity is a VIE, the reporting entity (primary beneficiary) should account for the initial consolidation pursuant to the guidance in ASC 810-10-30-4. A gain or loss may be recognized under this guidance. See CG 6 for more information.

In limited circumstances, a reporting entity that is determined to be the primary beneficiary of a VIE does not have an equity investment in the entity. In these cases, the primary beneficiary must consolidate 100% of the balance sheet and income statement of the VIE and should generally apply consolidation procedures as if it were the parent in a typical parent-subsidary relationship. These consolidation procedures include applying the acquisition method if the VIE is a business, and reflecting equity interests in the VIE held by other parties as a noncontrolling interest.

1.4.2 *When to reassess previous consolidation conclusions*

The assessment of whether a reporting entity has a controlling financial interest in an entity is performed on an ongoing basis, irrespective of the consolidation model being applied. No exception is provided for instances where a reporting entity only temporarily controls an entity.

An entity would continue to be assessed for consolidation under the VIE or VOE models based on the most recent determination of which model applies. However, the applicable consolidation model to apply may change on the occurrence of a triggering event. See CG 4.8 for further discussion of triggering events.

1.4.2.1 *Changes in interest*

A change in an investor's ownership interest can arise from several different types of transactions. The investor may purchase additional interests from, or sell a portion of its existing interest to, another investor or the investee. The investor's interest may also change if the investee itself issues shares to or buys shares from other investors or issues shares upon the exercise of employee stock options.

The accounting for changes in interest will depend on the determination of control before and after the transaction. When a reporting entity gains control (consolidates) or loses control (deconsolidates), the change is reflected prospectively from the date at which control transfers and a gain or loss is typically recorded.

When a reporting entity already consolidates a subsidiary, changes that do not result in losing control are recorded as equity transactions. See BCG 5.4 for further discussion on changes of interest that do not result in a loss of control.

In a transaction that is considered to be a transfer of net assets between entities under common control, the receiving entity reflects the transfer as a change in the reporting entity on a retrospective basis. ASC 805-50-30-5 applies to transfers of net assets between entities under common control and requires the receiving entity to reflect the transfer in a manner similar to a pooling of interests. The prior period financial statements would be restated to reflect the consolidation as of the date the

transferor and the receiving entity became under common control. The transferee's financial statements should report results of operations for the period in which the transfer occurs as though the transfer of assets occurred at the beginning of the earliest reporting period presented. However, note that the transferring entity's accounting would differ. See BCG 7.1.3.2 for further discussion on the accounting for changes in a reporting entity.

As noted in the following extract, in some cases there could be a difference between the carrying amounts of the assets and liabilities reflected in the consolidated parent's books and the carrying amounts in the books of the contributing entity. The receiving entity should record the assets based on the parent's basis and not that of the transferring entity. See BCG 7.1.3 for further discussion on the accounting by the receiving entity and BCG 7.1.4 for further discussion on the accounting by the transferring entity.

ASC 805-50-30-5

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because pushdown accounting had not been applied, then the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

1.4.2.2 Loss of control (deconsolidation)

A reporting entity can lose control of a subsidiary for a number of reasons, including the circumstances discussed below.

ASC 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.

Refer to BCG 5.5 for additional guidance with respect to deconsolidation following a loss of control. The reporting entity should also consider the applicability of the presentation and disclosure requirements for discontinued operations, as further discussed in FSP 27. Public companies should also assess the significance of a deconsolidated subsidiary (or a subsidiary that is probable of being

deconsolidated) under SEC Regulation S-X Rule 1-02(w) and the related pro forma financial information requirements under Rule 11-01(a)(4), as further discussed in SEC 4400 and 4560.

1.4.2.3 *Summary of changes in interest transactions (consolidation)*

Figure CG 1-4 summarizes the accounting for changes in interest. Public companies should also assess the significance of change in interest transactions (or probable change in interest transactions) in accordance with SEC Regulation S-X Rule 1-02(w) and the related pro forma financial information requirements under Rule 11-01(a)(4), as further discussed in SEC 4400 and 4560.

Figure CG 1-4
Overview of changes in interest

Change in interest		Accounting result	Impact to investor's financial statements	Discussed in
No existing investment. Acquisition of less than 100% of business acquired (partial acquisition)	Gain control	Consolidate as of the date control is obtained	Recognize 100% of identifiable assets and liabilities	BCG 5
		Recognize the NCI in equity	Recognize the NCI at fair value	
			Recognize 100% of goodwill	
Fair value (or measurement alternative¹) to consolidation of a business (step acquisition)	Gain control	Eliminate previously held equity interest and consolidate as of the date control is obtained	Recognize 100% of identifiable assets and liabilities	BCG 5
		Recognize a gain or loss, if any, on a previously held equity interest in the income statement	Remeasure the previously held equity interest to fair value and recognize any difference between fair value and carrying value, if any, as a gain or loss in net income	
		If less than 100% acquired, recognize the NCI in equity	Recognize 100% of goodwill	

Change in interest		Accounting result	Impact to investor's financial statements	Discussed in
			<p>If less than 100% interest is acquired:</p> <ul style="list-style-type: none"> □ Recognize the NCI at fair value □ Recognize 100% of goodwill or bargain purchase gain 	
Equity method to consolidation	Gain control	<p>Cease applying equity method and eliminate previously held equity interest; consolidate as of the date control is obtained</p> <p>Recognize the NCI in equity if less than 100% obtained</p>	<p>Remeasure the previously held equity method investment to fair value and recognize any difference between fair value and carrying value in net income</p> <p>Recognize 100% of identifiable assets and liabilities</p> <ul style="list-style-type: none"> □ Recognize the NCI, if any, at fair value □ Recognize 100% of goodwill or bargain purchase gain 	BCG 5, EM 5
Consolidation to consolidation (acquisition of interest)	Change of interest	Account for as an equity transaction	Do not recognize a gain or loss in the income statement	BCG 5

Change in interest	Accounting result	Impact to investor's financial statements	Discussed in
		Recognize the difference between the fair value of the consideration paid and the related carrying value of the NCI acquired in the controlling entity's equity	
		Reclassify the carrying value of the NCI obtained from the NCI to the controlling entity's equity	

Change in interest	Change of interest	Accounting result	Impact to investor's financial statements	Discussed in
Consolidation to consolidation (sale of interest)	Change of interest	Account for as an equity transaction	<p>Do not recognize a gain or loss in the income statement</p> <p>Recognize the difference between the fair value of the consideration received and the related carrying value of the controlling interest sold in the controlling entity's equity</p> <p>Reclassify the carrying value of the controlling interest sold from the controlling entity's equity to the NCI</p>	BCG 5
Fair value (or measurement alternative¹) to equity method	Significant influence (control not obtained)	May elect the fair value option	<p>Assuming the fair value option is not elected:</p> <ul style="list-style-type: none"> □ Determine basis differences for entire investment □ Recognize investment at investor's current basis of previously held interests plus cost of incremental investment, if any. 	EM 5.3.1

Change in interest		Accounting result	Impact to investor's financial statements	Discussed in
Consolidation to equity method	Loss of control but obtain/ retain significant influence – due to sale or dilution of interest	Cease consolidation accounting from the date control is lost. Apply equity method prospectively (not a change in accounting principle); may elect the fair value option The same accounting guidance applies to the loss of control of a subsidiary that is a VIE or voting interest entity	Deconsolidate investment and remeasure retained investment (noncontrolling interest) at fair value with gain or loss recognized in net income Assuming fair value option not elected: □ Retained investment (remeasured at fair value) forms initial cost basis of equity method investment. Determine basis differences. □ Prospectively recognize investor's share of equity investee's earnings based on retained interest, adjusted for the effects of basis differences, and other items	EM 5.4.1
Consolidation to fair value (or measurement)	Loss of control, and no longer hold significant influence	Change classification and measurement of investment	Deconsolidate investment	BCG 5

Change in interest	Accounting result	Impact to investor's financial statements	Discussed in
alternative¹⁾ or no retained interest	<p><i>Cease consolidation accounting and begin accounting for investment under other applicable guidance</i></p> <p>Recognize gain or loss on disposal and gain or loss on the retained noncontrolling investment in the income statement</p> <p>The same accounting guidance applies to the loss of control of a subsidiary that is a VIE or voting interest entity</p>	<p>Remeasure any retained noncontrolling investment at fair value</p> <p>Recognize gain or loss on interest sold and gain or loss on the retained noncontrolling investment in the income statement</p>	

¹ For equity securities without readily determinable fair value, ASC 321 allows measurement at cost minus impairment, if any, plus or minus changes resulting from observable price changes.

1.4.3 *Intercompany eliminations in consolidation*

The intercompany eliminations process for consolidated subsidiaries is discussed in CG 8.2. A consistent approach is followed for consolidated VIEs and voting interest entities, with one key exception. When consolidating a VIE, the effect of eliminating any *net* intercompany profit or loss may not be allocated to the noncontrolling interest; the full intercompany profit should be attributed to the primary beneficiary.

1.4.4 *Allocation of comprehensive income (consolidation)*

The guidance for the allocation of profits to noncontrolling interests does not distinguish between VIEs and voting interest entities consolidated by a reporting entity. No particular method is specified for attributing earnings between the controlling interest and the noncontrolling interest. If there is a contractual arrangement that determines the attribution of earnings, such as a profit-sharing agreement, the attribution specified by the arrangement should be considered if it is determined to be substantive (see EM 4.1 for discussion of profit or loss allocation in these situations). If there is not a contractual arrangement, then the relative ownership interest generally should be used as the basis for attribution of earnings between controlling and noncontrolling interests.

Since the same principles are applied to a consolidated VIE, a parent (the primary beneficiary) should show a negative noncontrolling interest position (debit balance) related to a consolidated VIE if the subsidiary generates losses that would cause the noncontrolling interest balance to decrease below zero. That is, losses should continue to be attributed to the noncontrolling interest even if that attribution results in a deficit noncontrolling interest balance.

Excerpt from ASC 810-10-35-3

The principles of consolidated financial statements in this Topic apply to primary beneficiaries' accounting for consolidated variable interest entities (VIEs). After the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE shall be accounted for in consolidated financial statements as if the VIE were consolidated based on voting interests.

It is common for some of the equity holders of a VIE to also be employees of the primary beneficiary. Depending on the facts and circumstances, such distributions may be compensatory (therefore requiring expense recognition) or, may be no different than what an independent investor would receive.

The following factors are indicative of the distributions being similar to those of an independent investor:

- Appropriate value was received by the VIE in exchange for the distribution (i.e., the relationship between invested capital and distributions should be considered)
- There is no linkage between the distributions to be made and the employment of the common shareholders of the VIE
- Distributions are commensurate with each investor's ownership interest
- Distributions are made to all residual equity holders of the entity
- There are no agreements between the primary beneficiary and the residual equity holders that expressly guarantee distribution to the investors
- The noncontrolling interests qualify for equity classification under applicable GAAP

See BCG 6.4.1 for a discussion of the allocation of net income and comprehensive income between the controlling and noncontrolling interests.

Chapter 2:
Scope of consolidation
guidance—updated
December 2023

2.1 *Scope of consolidation guidance*

Reporting entities are required to evaluate the provisions of ASC 810-10 to determine whether and how to consolidate another entity. ASC 810-10 exempts certain legal entities from consolidation, but those exceptions are relatively few.

The first step in applying the consolidation framework requires a reporting entity to consider whether the VIE model applies. Only certain specified legal entities (e.g., not-for-profit entities and life insurance entities) do not need to be evaluated using the VIE model. These entities still need to be evaluated for potential consolidation under the voting interest consolidation model discussed in CG 7.

Legal entity definition

Any legal entity, regardless of its legal form or scope of its activities, is subject to potential consolidation absent an applicable scope exception. The ASC Master Glossary provides a definition of a legal entity.

Definition from ASC Master Glossary

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

The definition of legal entity is intentionally broad. It includes all legal structures established to manage or administer activities of any kind, or to hold assets or incur liabilities. However, the term does not extend to individuals.

Concluding that an arrangement involves a legal entity requires that all relevant facts be considered. Consider the following examples:

- A franchise agreement may be entered into between a franchisor and an individual. This arrangement does not fall within the scope of the consolidation model, as the franchisee is a person. On the other hand, if the franchise agreement is between the franchisor and a legal entity (e.g., a corporation, partnership, limited liability company, or unincorporated entity), the legal entity would be subject to potential consolidation by the franchisor even when the franchisee is wholly owned by an individual.
- In the insurance industry, it is common practice to use syndicates to accept insurance business on behalf of the syndicate's members. Depending on the legal form of the structure, some syndicates may involve a legal entity (e.g., a partnership). Other syndicate arrangements may pose no consolidation implications, as no legal structure or form is used to effect the members' underwriting activities.

Other situations exist when multiple parties jointly undertake an endeavor that is not wholly or partially conducted through a separate legal entity. If companies are subject to the collaborative arrangements guidance in ASC 808, the VIE model does not apply. See CG 8.3 for further details on accounting for collaborative arrangements.

2.1.1 ***Factors impacting the legal entity determination (consolidation)***

Determining whether an entity is a legal entity potentially subject to consolidation may require the exercise of judgment. The determination is often obvious, such as when there is an incorporated legal entity (e.g., a corporation). Other times it may be less clear.

Factors to consider when evaluating whether a structure is a legal entity include whether:

- It meets the definition of a legal entity in the resident country. Even if it does not, the structure may have characteristics similar to those of a legal entity in the US. For example, an unincorporated foreign joint venture may have characteristics similar to those of a US partnership or limited liability company
- It is permitted to enter into contracts under its own name (i.e., not in the name of the partners or parent company)
- It has legal standing to enforce contracts or exercise creditor rights and, conversely, can be sued on a standalone basis
- The liability of the partners or investors are limited, or the liabilities of the structure flow through to the partners
- It is recognized for tax purposes, such as if a tax return is filed in the structure's name
- It can open a bank account in its own name

It may be necessary to seek the advice of an attorney to fully understand the legal characteristics of the structure and to clarify what activities the structure can legally undertake on a standalone basis. Additionally, it is possible that one indicator may not be conclusive in judging whether the entity is, in fact, a legal entity.

All relevant factors should be considered, and the analysis may differ depending on the structure being evaluated. For example, ASC 810-10-55-8A through ASC 810-10-55-8H illustrates mutual funds under the Investment Company Act of 1940 that are structured as separate series within an overall umbrella legal entity (trust). Each series fund is represented by a separate share class of the trust or corporation and the proceeds from the issuance of the share class are invested in assets according to the strategy of the series fund. In a series mutual fund that is subject to the 1940 Act, the trust or corporation is governed by a single board of directors that is responsible for overseeing the operations of each series fund.

In the example, each separate series 1940 Act mutual fund is determined to be a legal entity based on each series fund having its own:

- investment objectives and policies,
- custodial agreement,
- shareholders, separate from other series funds,
- unique tax identification number,

- separate tax returns filed with the Internal Revenue Service,
- separate audited financial statements, and
- investor protections in virtually all circumstances (afforded under the 1940 Act by the SEC staff's Division of Investment Management).

These factors may not be present in other similar series structures, including in other jurisdictions. As a result, in other situations, the umbrella legal entity may be the only level at which consolidation should be considered.

Within the VIE model, a portion of a legal entity, referred to as a “silo,” may also be deemed to be subject to potential consolidation. See CG 3.8 for more information.

2.1.2 “Virtual” SPEs or portions of legal entities

ASC 810-10-15-15 affirms that “virtual SPEs” (divisions, departments, branches, or pools of assets subject to liabilities that are otherwise nonrecourse to other assets of the broader entity) are not considered separate entities for purposes of applying the VIE model. However, if the entire legal entity is deemed a VIE, there are circumstances in which a virtual SPE or “silo” may be considered a separate entity and subject to the VIE guidance, possibly resulting in consolidation. Silos are discussed in more detail in CG 3.8.

2.1.3 Consolidation of majority-owned or wholly-owned subsidiaries

ASC 810-10-15-9 clarifies that a wholly- or majority-owned subsidiary is subject to the VIE model and may be a VIE. If the subsidiary is a VIE, a reporting entity other than the subsidiary’s legal parent may be required to consolidate it under the VIE model. In this case, the subsidiary’s legal parent would not consolidate the subsidiary and instead would likely report its equity interest using other applicable GAAP (e.g., ASC 323 for equity method investments).

Example CG 2-1 illustrates a reporting entity’s VIE assessment of a majority-owned subsidiary.

EXAMPLE CG 2-1

Majority-owned subsidiaries: VIE assessment

Reporting Entity A holds all of the voting shares of Entity XYZ and has previously consolidated Entity XYZ under the voting interest entity model. During the current reporting period, Entity XYZ enters into a contractual arrangement with Reporting Entity B that conveys to Reporting Entity B certain decision-making rights with respect to, and an entitlement to economic returns from, Entity XYZ. Reporting Entity B holds no equity investment in Entity XYZ.

What are the potential consolidation implications for Reporting Entity A and Reporting Entity B stemming from the new contractual arrangement?

Analysis

Since the entities are not exempt from the VIE model, Reporting Entity A, Reporting Entity B, and other parties that hold variable interests in Entity XYZ must determine whether Entity XYZ is a VIE. Upon executing their contractual arrangement, Reporting Entity A and Reporting Entity B each must

evaluate whether it should consolidate Entity XYZ. It is possible that Reporting Entity B could be required to consolidate Entity XYZ, even though it does not own an equity investment in Entity XYZ.

2.2 *Scope exceptions to the consolidation guidance*

The consolidation guidance in ASC 810 does not apply to certain legal entities. ASC 810-10-15-12 clarifies that a reporting entity should not apply the consolidation guidance to (1) employers' interests in employee benefit plans (see CG 2.2.1), (2) investment companies (see CG 2.2.2), (3) governmental organizations (see CG 2.2.3), and (4) money market funds (see CG 2.2.4).

2.2.1 *Employers' interests in employee benefit plans*

An employer that sponsors an employee benefit plan is exempt from consolidating that plan.

ASC 810-10-15-12(a)

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

Non-leveraged employee stock ownership plans (ESOPs) are defined contribution plans and are similar in important respects to pension arrangements covered by ASC 715, *Compensation—Retirement Benefits* (ASC 715). Consequently, we believe that non-leveraged ESOPs are also excluded from the consolidation model under this scope exception.

This scope exception does not apply to a service provider who is not the sponsoring employer to an employee benefit plan. The service provider is obligated to perform its consolidation evaluation applying the applicable VIE or VOE consolidation model.

Although an employer that sponsors an employee benefit plan is not required to consolidate that plan, the exception does not extend to an employee benefit plan itself. However, defined-benefit plans that fall within the scope of ASC 960, *Plan Accounting—Defined Benefit Pension Plans* (ASC 960), and defined-contribution plans that fall within the scope of ASC 962, *Plan Accounting—Defined Contribution Pension Plans* (ASC 962), should continue to follow the guidance of ASC 960 and ASC 962, respectively. We do not believe that it is intended to require employee benefit plans to consolidate entities in which they invest.

2.2.2 *Investment companies*

Investment companies are not generally required to evaluate their investees for consolidation.

ASC 810-10-15-12(d)

Except as discussed in paragraph 946-810-45-3, an investment company within the scope of Topic 946 [*Financial Services—Investment Companies*] shall not consolidate an investee that is not an investment company.

This scope exception only applies to investments that are reported at fair value and are owned by a reporting entity that qualifies as an investment company under the guidance of ASC 946.

The scope exception does not apply to reporting entities that hold interests in an investment company. An investor, investment adviser, or any other party having an interest in an investment company entity under ASC 946 must evaluate whether it should consolidate the investment company.

A reporting entity that consolidates an investment company retains the investment company's specialized accounting in the reporting entity's consolidated financial statements, as noted in ASC 810.

ASC 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.

2.2.3 Governmental organizations

Governmental organizations assessing whether they should consolidate another entity should follow the guidance established by the Governmental Accounting Standards Board.

It is generally not appropriate for a non-governmental reporting entity to consolidate a governmental organization or a financing entity established by a governmental organization. There may be limited circumstances when consolidation of a financing entity established by a governmental organization may be appropriate, as discussed in ASC 810-10-15-12(e).

ASC 810-10-15-12(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 Entity Subsections.

The term *governmental organization* is described in the AICPA Audit and Accounting Guide.

Excerpt from the AICPA State and Local Government Audit Guide 1.01

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

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;
- The potential for unilateral dissolution by a government with the net assets reverting to a government; or
- 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, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

Excerpt from AICPA State and Local Government Audit Guide 1.02

Organizations are governmental or nongovernmental for accounting, financial reporting, and auditing purposes based solely on the application of the preceding criteria; other factors are not determinative. For example, the fact that an entity is incorporated as a not-for-profit organization and exempt from federal income taxation under the provisions of IRC Section 501 is not a criterion in determining whether an organization is governmental or nongovernmental for accounting, financial reporting, and auditing purposes.

Whether an entity is a governmental organization or a financing entity established by a governmental organization requires careful consideration. Examples of governmental entities that would not be subject to consolidation include, but are not limited to:

- A governmental organization (or a financing entity established by a governmental organization) that issues tax-exempt debt to finance the construction of an asset leased to the reporting entity
- A tax-increment financing entity established by a municipality to finance certain infrastructure assets on land owned by the reporting entity (commonly referred to as industrial development bonds)

In practice, the governmental scope exception can be difficult to apply, particularly when dealing with an entity established by a governmental organization to finance a project of the reporting entity. If an entity does not meet the definition of a governmental organization, further consideration should be given to whether the entity is, in substance, a financing entity established by a governmental organization. This analysis is subjective and requires an understanding of all of the facts and circumstances.

Although not intended to be all inclusive, some of the factors that may warrant consideration when making the determination of whether an entity is a governmental organization include:

- What was the extent and nature of the government's involvement in establishing the entity?
- What role, if any, did the government play in selecting the entity's board members (and/or selecting individuals responsible for directing the activities of the entity)?
- Does the government have the right to unilaterally dissolve the entity?
- What percent (or relative magnitude) of the entity's activities are conducted on behalf of the government?
- What are the terms of the contract between the government and the entity?
- Do the assets revert back to the government at the end of the contract term?

- Did the government provide any guarantees to the entity?

In addition, consideration should be given to whether the entity was set up to circumvent the VIE model for the purpose of obtaining off-balance sheet treatment for the reporting entity. When making this assessment, the intent and purpose of the entity, as well as whether the reporting entity was involved in the entity's design should be considered.

Example CG 2-2 illustrates the application of the governmental scope exception.

EXAMPLE CG 2-2

Governmental organization scope exception

Entity A was formed through a competitive bidding process (overseen by a governmental entity) to issue revenue bonds to finance the construction of a power plant (the "facility"). Although Entity A legally owns the facility, the facility was constructed for the sole benefit of a governmental entity.

The equity investors (i.e., owners) of Entity A are in the business of building and managing power plants. The facility was constructed on government-owned land, with the land being leased to Entity A for the estimated life of the facility. At the end of the land lease term, title to the facility will automatically transfer to the governmental entity.

At the inception of the land lease, the governmental entity simultaneously entered into an arrangement with Entity A that requires the governmental organization to purchase 100% of the output of the facility (i.e., electricity) on a long-term basis. The governmental entity also holds a fair value purchase option that allows it to purchase the facility from Entity A at any time during the lease term.

As part of a competitive bidding process, Company X, a party that is unrelated to both Entity A and the governmental entity, entered into an arrangement with Entity A to guarantee the revenue bonds. Company X was not involved in the design of Entity A and there are no indications that Entity A was established in an effort to circumvent the provisions of the VIE guidance.

Does Entity A qualify for the governmental organization scope exception?

Analysis

Factors that suggest Entity A is a financing entity established by a governmental organization include (1) the governmental entity was integral in the design and is a party to all the critical agreements of Entity A, (2) Entity A was established to finance and construct a power plant whose entire output is intended to be sold to that governmental entity, and (3) it is intended that the governmental entity will ultimately own Entity A's assets. As a result, even though Entity A would not meet the GASB or Federal Accounting Standards Advisory Board definition of a governmental organization, it is likely that Company X would conclude that Entity A is a financing entity established by a governmental organization and, therefore, would qualify for the governmental organization scope exception. Therefore, Company X would not be required to consolidate Entity A.

2.2.4 Money market funds

The money market funds scope exception applies to all investors and other variable interest holders in a qualifying fund.

ASC 810-10-15-12(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 scope 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.

Registered money market funds are required to invest in securities issued by entities with minimal credit risk with a short duration (considering individual securities and the average maturity of the portfolio). In addition, they are subject to constraints related to credit risk and diversification.

Unregistered money market funds that operate in a manner similar to registered money market funds are also eligible for the scope exception. Determining whether an unregistered money market fund is similar to a registered money market fund will require judgment. The unregistered money market fund's purpose and design, as well as the risks it was designed to create and pass along to its interest holders, should be considered in assessing whether the fund operates in a manner similar to a registered money market fund. The structure and intended outcome of the fund may also be relevant factors to consider.

Therefore, in assessing whether an unregistered fund is similar to a registered fund, the quality, maturity, and diversification of the fund's portfolio should be considered. Figure CG 2-1 poses helpful questions to consider in this assessment.

Figure CG 2-1
Assessing unregistered money market funds

Characteristic	Description
Portfolio quality	Does the fund invest in high-quality, short-term securities with credit risk similar to those held by registered money market funds?
Portfolio maturity and diversification	Are the fund's objectives consistent with the objectives of a registered money market fund? In particular, with regard to the: <ol style="list-style-type: none"> (1) credit quality of its eligible investments, (2) diversification of the portfolio, (3) maximum maturity of eligible investments, and (4) average maturity of the portfolio.

ASC 810-10-15-12(f) requires reporting entities that have provided, or have explicit arrangements to provide, financial support to entities subject to this exception to provide specified disclosures. See FSP 18 for disclosure requirements.

2.3 *Scope exceptions to the VIE model*

In addition to the general consolidation scope exceptions, ASC 810-10-15-17 lists a limited number of circumstances when a reporting entity is not required to apply the VIE model to a legal entity in which it has an interest.

Although certain of the scope exceptions appear straightforward, their application may require judgment and consideration of the circumstances. Moreover, the reporting entity must continually reassess whether a previously identified scope exception continues to apply.

2.3.1 *VIE scope exception — not-for-profit organizations*

This scope exception applies to all reporting entities subject to the consolidation requirements in ASC 958, *Not-for-Profit Entities—Consolidation* (ASC 958).

ASC 810-10-15-17(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 in the Variable Interest Entities Subsections, that NFP shall be subject to the guidance in the Variable Interest Entities Subsections.

The exception also applies to NFP health care organizations subject to the AICPA Audit and Accounting Guide, *Health Care Organizations*. Under this scope exception:

- NFPs do not have to analyze their relationships with potential VIEs, since NFPs are not subject to the VIE model; and

- A for-profit reporting entity is not required to apply the VIE model to an NFP unless the NFP was established to avoid consolidation under the VIE model.

In the latter case, a for-profit reporting entity with a relationship with an NFP entity should apply the VIE model to determine whether the NFP is a VIE and, if so, conclude whether the reporting entity is the NFP's primary beneficiary.

Based on the guidance in ASC 810-10-25-43, an NFP may be a related party of a for-profit reporting entity. If so, when evaluating whether the for-profit reporting entity is the primary beneficiary of a for-profit VIE, the reporting entity must consider the involvement of the related party NFP, including any variable interest in the VIE or any power over the VIE's significant activities held by the related party NFP.

Refer to NP 5.2 for further details on the consolidation requirements in ASC 958 for NFPs.

2.3.2 **VIE scope exception — life insurance entities**

Separate accounts of life insurance entities are not subject to consolidation by another reporting entity under the VIE model. ASC 944-80, *Financial Services—Insurance, Separate Accounts*, prescribes that separate account assets and liabilities should be included in the financial statements of the insurer that owns the assets and is contractually obligated to pay the liabilities.

ASC 810-10-15-17(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.

Separate account arrangements are considered to be separate investment entities and, as such, may have separate reporting requirements. For purposes of the stand-alone reporting requirements, separate account arrangements governed by SEC Regulation S-X, Rule 6-03(c)(1) are eligible for the same scope exception from ASC 810 as other registered investment companies, as discussed in CG 2.2.2. That discussion is also relevant for non-registered separate accounts subject to the AICPA Audit and Accounting Guide, *Investment Companies*.

ASC 944-80-25-3(d) clarifies that a separate account's specialized accounting for investments is to be retained in the financial statements of the sponsoring insurer. That is, an insurance entity does not consolidate an investment in which a separate account has a controlling financial interest if the investment is not required to be consolidated in the stand-alone financial statements of the separate account.

Note that the scope exception for separate accounts does not extend to investments held by an insurer's general account. An insurer must consider the consolidation implications for any investments held by its general account based on the relevant guidance in ASC 810. Further, as directed by ASC 944-80-25-3(f), separate account interests held for the benefit of a related party policyholder are to be combined with the insurer's general account interest when the VIE analysis requires consideration of related parties.

2.3.3 *VIE scope exception – “information-out”*

When FIN 46R was issued, the FASB recognized that there may have been instances where reporting entities entered into arrangements prior to December 31, 2003 that, for a variety of reasons, did not permit them to obtain the information necessary to apply the VIE model.

ASC 810-10-15-17(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.

As the excerpt states, these instances were expected to be infrequent, especially if the reporting entity was involved in the design of the entity or if the reporting entity was exposed to substantial risks of the entity.

We have noted very few reporting entities disclosing this exception in their financial statements. Considering the amount of time that has elapsed since FIN 46R’s release in 2003, we expect it to be rare and unusual for a reporting entity to invoke this exception.

2.3.4 *VIE scope exception – business scope exception*

Determining whether the VIE model applies to an entity that meets the definition of a business can be one of the more challenging aspects of ASC 810. The VIE model provides the following scope exception (the “business scope exception”) for reporting entities having a variable interest(s) in a business entity.

ASC 810-10-15-17(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).

The VIE model addresses situations where the voting interest entity approach may not identify the party having a controlling financial interest in an entity. When deliberating FIN 46R, the Board considered, but ultimately opposed, providing a scope exception for all businesses, believing that such a distinction was contrary to the principle underlying the VIE model. Therefore, ASC 810-10-15-17(d) is not intended to provide a scope exception to all businesses.

The business scope exception allows reporting entities to avoid applying the VIE model in circumstances where it is unlikely that the reporting entity would be required to consolidate a business (as the primary beneficiary), even if the entity is a VIE. The Board concluded that the most useful way to provide this implementation relief would be through a targeted scope exception consisting of a series of conditions that, if met, would obviate the need for further analysis under the VIE model.

The criteria in the business scope exception focus on the relationships between the reporting entity and the legal entity. Whether the entity has the characteristics of a VIE, as specified in ASC 810-10-15-14, is not relevant. Each reporting entity with an interest in the entity is required to separately evaluate its relationships with the entity. The fact that one reporting entity concludes that the legal entity being evaluated is eligible for the business scope exception does not provide the basis for another reporting entity to conclude similarly. In fact, one reporting entity may conclude that the entity meets the business scope exception, while another reporting entity involved with the same entity may not and may conclude that the entity is a VIE.

Although the application of the business scope exception may seem straightforward, it is not. The analysis involves evaluating several factors in addition to the specific facts and circumstances of the transaction. The first step is to determine whether the entity is a business. The second step is to determine whether any of the four conditions cited in ASC 810-10-15-17(d) are met. If any of the four conditions is present, the reporting entity is precluded from utilizing the scope exception. If a reporting entity concludes that the business scope exception is met, the reporting entity should evaluate whether the exception remains satisfied at each subsequent reporting period.

Is the legal entity a business?

To apply the business scope exception, the reporting entity must determine whether or not the entity is a business. ASC 805 provides a framework for entities to use in evaluating whether an integrated set of assets and activities (collectively a “set”) should be accounted for as a business or a group of assets. It includes an initial screen to determine if substantially all of the fair value of the gross assets is concentrated in a single asset or group of similar assets. If that screen is met, the set is not a business. Refer to BCG 1.2 for further guidance on evaluating whether an entity is a business.

Assuming that a reporting entity concludes that the entity in question is a business, it may invoke the business scope exception, provided that none of the conditions in ASC 810-10-15-17(d) are met.

Condition 1: design of the entity – business scope exception**ASC 810-10-15-17(d)(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.

ASC 810-10-15-17(d)(1) is a condition that requires an understanding of the dynamics behind the entity’s design or redesign (the “design of the entity” condition). Indicators that the reporting entity was involved in the design (or redesign) of the entity include participating in the establishment of:

- capital structure,
- governance structure, or
- operating activities.

The scope exception may not be applicable if:

- a reporting entity is involved in the formation of an entity or holds a majority financial interest shortly after the formation of the entity as it may have participated significantly in the design of the entity,
- a reporting entity that acquires a significant financial interest in an entity, negotiates modifications to the governance provisions or operating activities of the entity, or establishes or amends a shareholders’ agreement as part of the transaction, or
- changes to the entity’s capital structure or governance documents in connection with the acquisition of a financial interest or variable interest in an entity indicate that the reporting entity participated significantly in the design or redesign of the entity.

In connection with this analysis, the reporting entity must determine whether its related parties participated in these activities. If so, the scope exception may not be available. As described in the

exception, for purposes of evaluating the design of the entity condition, related parties include certain de facto agents.

If an entity undergoes a redesign or restructuring, the reporting entity must re-evaluate this condition, taking into account the nature and extent of its involvement, if any, with those changes.

There are two instances when involvement in the design of the entity does not preclude a reporting entity from applying the business scope exception:

- *Operating joint ventures under joint control of the reporting entity and one or more unrelated parties*

To qualify for this exception, the entity must meet the definition of a joint venture as defined in the ASC Master Glossary.

Definition from ASC Master Glossary

Joint Venture: An entity owned and operated by a small group of businesses (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 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 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 joint venture. The ownership of a joint venture seldom changes, and its equity interests usually are not traded publicly. A minority public ownership, however, does not preclude an entity from being a joint venture. As distinguished from a corporate joint venture, a joint venture is not limited to corporate entities.

An operating joint venture must comply with the remaining conditions in ASC 810-10-15-17(d) to qualify for the business scope exception. Refer to EM 6 for further discussion on operating joint ventures.

- *Franchisees*

Absent this carve-out, all franchisee entities, as defined in the ASC Master Glossary, would meet the design of the entity condition, and because the condition was present, would be precluded from applying the business scope exception. However, the FASB does not believe that all entities holding franchise agreements are, by definition, VIEs. Therefore, to alleviate the burden of applying the VIE model to franchisees, the Board decided that the design of the entity condition does not apply to an entity that is a franchisee.

Franchisee entities must comply with the remaining conditions in ASC 810-10-15-17(d) to qualify for the business scope exception.

Condition 2: the “substantially all” test – business scope exception**ASC 810-10-15-17(d)(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.

Entities having a narrow business purpose intended to complement the reporting entity’s operating or financing activities will generally meet the substantially all test. Most questions regarding this condition involve the appropriate interpretation of the phrase “substantially all of its activities either involve or are conducted on behalf of.” This phrase is also used to characterize entities established with non-substantive voting rights (see ASC 810-10-15-14(c)), and thus we believe that this condition should be interpreted and applied in a consistent manner.

As a general rule, we believe that this assessment is primarily qualitative. Some have suggested that the phrase *substantially all* should be interpreted to mean that 90% or more of the economics of the entity relate or accrue to the benefit of a particular party. We believe that such a quantitative measure is only one of many factors that should be considered in evaluating this criterion. However, we recognize there may be circumstances where the economics of the arrangement are so skewed in the direction of one reporting entity that a quantitative analysis may, in and of itself, override other considerations.

Figure CG 2-2 lists indicators that may assist in the evaluation of whether the substantially all criterion has been met.

Figure CG 2-2

Indicators of whether the “substantially all” criterion have been met

Strong indicators¹	Other indicators¹
<ul style="list-style-type: none"> □ The reporting entity sold assets to the entity in an effort to remove underperforming assets from the reporting entity’s balance sheet. 	<ul style="list-style-type: none"> □ The reporting entity sold assets to the entity.
<ul style="list-style-type: none"> □ The entity’s major activities include selling substantially all of its products to the reporting entity under long-term contracts. 	<ul style="list-style-type: none"> □ The entity’s major activities include selling a majority of its products to the reporting entity, and these arrangements are expected to continue either because of long-term contracts or for other reasons.
<ul style="list-style-type: none"> □ The entity’s major activities include purchasing substantially all of its purchased products from the reporting entity. 	<ul style="list-style-type: none"> □ The entity’s major activities include purchasing a majority of its purchased products from the reporting entity.

Strong indicators¹	Other indicators¹
<ul style="list-style-type: none"> □ The reporting entity holds a non-reciprocal, fixed-price or “in-the-money” call option on the other investors’ equity investments, and/or the other investors have a fixed-price or “in-the-money” put option whereby they can put their investments to the reporting entity. 	<ul style="list-style-type: none"> □ The reporting entity holds a non-reciprocal, fair-value call option on the other investors’ equity investments, and/or the other investors have a similarly priced, non-reciprocal put option.
<ul style="list-style-type: none"> □ The reporting entity is obligated to provide substantially all of any additional capital contributions that may be necessary to cover operating shortfalls. 	<ul style="list-style-type: none"> □ The reporting entity is obligated to provide a majority of any additional capital contributions that may be necessary to cover operating shortfalls.
<ul style="list-style-type: none"> □ The entity performs research and development activities, and the reporting entity has an economic interest (e.g., through a purchase option) in the results of the research that constitutes substantially all of the entity’s activities. 	<ul style="list-style-type: none"> □ The entity performs research and development activities, and the reporting entity is in a business that could capitalize on the results of the research that constitutes a majority of the entity’s activities.
<ul style="list-style-type: none"> □ The reporting entity has outsourced operations to the entity, constituting substantially all of the entity’s activities. 	<ul style="list-style-type: none"> □ The reporting entity has outsourced to the entity operations that constitute a majority of the entity’s activities.
<ul style="list-style-type: none"> □ Substantially all of the entity’s assets are leased to the reporting entity. 	<ul style="list-style-type: none"> □ A majority of the entity’s assets are leased to the reporting entity.
<ul style="list-style-type: none"> □ The principal activity of the entity is to provide financing (e.g., loans or leases) to the reporting entity’s customers. 	<ul style="list-style-type: none"> □ A majority of the entity’s activities involve providing financing (e.g., loans or leases) to the reporting entity’s customers.
<ul style="list-style-type: none"> □ The principal purpose of the entity is to conduct a business that is uniquely complementary to a significant business operation of the reporting entity and is not similar to activities of other participants in the entity. 	<ul style="list-style-type: none"> □ The principal purpose of the entity is to conduct a business that is more closely related to a significant business operation of the reporting entity and only broadly similar to activities of one or more of the other participants in the entity.
<ul style="list-style-type: none"> □ The economics (e.g., capital at risk, participation in profits, etc.) are heavily skewed (e.g., close to 90% or greater) toward the reporting entity. 	<ul style="list-style-type: none"> □ The economics (e.g., capital at risk, participation in profits, etc.) are weighted (e.g., greater than 60%) toward the reporting entity.

¹ With respect to evaluating these indicators, the term “reporting entity” includes the reporting entity’s related parties (as defined in ASC 810-10-25-43).

There are no broad “rules of thumb” or “bright lines” to shortcut the evaluation of the substantially all condition. Instead, reporting entities should assess all facts and circumstances; judgment is required. Absent mitigating factors (i.e., indicators that point to a different conclusion), a single item from the “Strong indicators” column may, at times, be sufficient to support a conclusion that substantially all of the activities of the entity either involve or are conducted on behalf of the reporting entity. If the

reporting entity meets several of the “Other indicators,” evaluating whether the substantially all condition has been met warrants careful consideration.

To protect the brand, franchise agreements between a franchisor and a franchisee often incorporate unique terms and provisions. As a result, these agreements should be analyzed carefully. Figure CG 2-2 should prove useful when evaluating whether a franchise arrangement is designed such that substantially all of the franchisee’s activities either involve or are conducted on behalf of the franchisor. However, there may be other factors to consider in the franchise relationship, including the ability to select and set pricing of the menu (or products sold by the franchisee), as well as other indicators, some of which are described in more detail in ASC 952, Franchisors, specifically in ASC 952-810-55-2.

Condition 3: subordinated financial support – business scope exception

ASC 810-10-15-17(d)(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.

Determining whether the reporting entity and its related parties provide more than half of the financial support to the entity requires consideration of two defined terms from the ASC Master Glossary:

Definitions from ASC Master Glossary

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

Expected Losses (excerpt): 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 of variability of the net income or loss.

When evaluating this condition, a reporting entity should consider all variable interests that it and other parties have with the entity, including variable interests in the form of guarantees, management contracts, derivatives, purchase options, and supply contracts, as well as loans and equity investments. It may not be easy to inventory such interests, and related fair-value information is often not available. Therefore, this assessment may be difficult to undertake in practice, particularly in situations where the reporting entity’s financial support to the entity is substantial (and/or takes various forms).

As a practical matter, the business scope exception will generally be available only when it is obvious that the reporting entity will not absorb the majority of the economics of the entity on a fair value basis. For certain arrangements – for example, a 50:50 joint venture – it may be difficult to make this assertion. In a 50:50 venture, although the entity’s economics are intended to be equally shared, that may not be the case when viewed in more detail. There may be other commercial arrangements between the owners and the venture that constitute variable interests, such as in the form of guarantees, supply contracts, or management agreements. In these instances, absent a comprehensive analysis, it may be difficult to demonstrate that the reporting entity does not hold a majority of the

economic interests in the venture. Therefore, in these circumstances, it is more likely than not that the entity will warrant evaluation under the VIE model.

Condition 4: common financing structures – business scope exception

ASC 810-10-15-17(d)(4)g

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

The assessment of this condition (the “common financing structure” condition) is relatively straightforward. This criterion is intended to ensure that entities considered “typical” SPE structures – trusts that securitize receivables, issuers of collateralized loan obligations and the like – are assessed under the VIE model.

In applying this condition, we believe that the phrase “single-lessee leasing arrangements” should be interpreted broadly. That is, we believe the term includes entities that have entered into long-term supply arrangements containing an embedded lease under ASC 842-10-15-3. When an entity is deemed to be a single-lessee leasing arrangement, the reporting entity would not be eligible for the business scope exception.

2.3.5 VIE scope exception – private company exception

A reporting entity that is a private company is not required to apply the VIE guidance to legal entities under common control (including common control leasing arrangements) if the parent and the legal entities being evaluated for consolidation are not public business entities.

The accounting alternative is an accounting policy election that a private company should apply to all legal entities under common control that meet the criteria in ASC 810-10-15-17AD. In other words, the alternative cannot be applied to some common control arrangements and not to others. If the alternative is elected, a private company will continue to apply other consolidation guidance in ASC 810, as applicable.

ASC 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.
- 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.

To determine if the private company (reporting entity) and the legal entity are under common control of a parent solely for the purpose of applying ASC 810-10-15-17AD(a), reporting entities would only consider a parent's direct and indirect voting interests in the private company and the legal entity. In other words, the guidance in the Variable Interest Entities Subsections of ASC 810 is not applied when making this determination. See ASC 810-10-55-205AV through ASC 810-10-55-205AZ for illustrative examples on determining whether common control exists solely for purposes of applying the accounting alternative, and ASC 810-10-55-205BA through ASC 810-10-55-205BF for illustrative examples on the application of the alternative.

If a reporting entity meets the criteria for the exemption and then at a future date any of the criteria cease to be met, a private company will apply the VIE guidance at the date of change on a prospective basis, except for situations in which a reporting entity becomes a public business entity. If the reporting entity becomes a public business entity, the entity would apply the VIE guidance in accordance with ASC 250 on accounting changes.

A private company is required to provide detailed disclosures about its involvement with and exposure to a legal entity under common control, as specified in ASC 810-10-50-2AG through ASC 810-10-50-2AI, unless the legal entity is consolidated by the reporting entity through accounting guidance other than VIE guidance.

Refer to FSP 18.9 for more information on the necessary disclosures.

Chapter 3:
Variable interests—updated
July 2022

3.1 Variable interests

A reporting entity must first determine whether it holds a “variable interest” in an entity to be evaluated for potential consolidation under ASC 810. If a reporting entity concludes that it holds a variable interest in an entity, it must evaluate whether that entity is a VIE. That assessment, in turn, will dictate which of the two consolidation models—the VIE model or the voting interest model—applies to the entity in question.

Variable interests can take many forms, including equity and debt investments, guarantees, derivatives, management contracts, service contracts, and leases. In many instances, concluding whether an instrument or contract is a variable interest may require only a cursory analysis. In other cases, however, the evaluation may not be as straightforward. Moreover, variable interests can exist in implicit relationships, especially if related party relationships are involved. For example, an implicit variable interest may exist if a reporting entity can be compelled to protect a related party entity from making losses or to make funds available to that entity.

3.1.1 What is a “variable interest”?

ASC 810-10-20 defines the term *variable interest* as follows.

Excerpt from ASC 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.

Expressed more simply, a variable interest is an economic arrangement that exposes or entitles a reporting entity to the economic risks and/or rewards of the entity—that is, the instrument or contract exposes its holder to an entity’s “variability.” ASC 810 frequently characterizes a variable interest as an interest that “absorbs” some or all of the variability that the entity was designed to create.

Not all instruments or contracts to which a reporting entity is a party are its variable interests—certain of those instruments and contracts create or generate the variability that the entity intends to pass on to its variable interest holders. ASC 810-10-55-19 articulates this concept.

ASC 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 entity’s variability—that distinguishes a variable interest. That role, in turn, often depends on the design of the legal entity.

Most assets of an entity create variability in an entity. They generate the cash flows that drive the success or failure of the entity, and therefore drive the economic performance (variability) of the

entity. Most forms of financing or capital (including guarantees of debt and/or assets, and some derivative instruments) absorb variability in an entity (or in an asset). The return to the lender or capital provider is contingent upon the relative performance of the assets (or, in some cases, liabilities). Only those arrangements that absorb the variability of the entity are considered variable interests under the VIE model.

The “by design” approach serves as the framework for differentiating between an entity’s assets—that is, those items intended to “create” an entity’s variability—and its variable interests.

Example CG 3-1 and Example CG 3-2 demonstrate the identification of a variable interest.

EXAMPLE CG 3-1

Identifying variable interests

An entity’s primary activities involve the manufacture and sale of furniture. The entity purchases supplies and/or services from vendors, employees, and other parties to conduct its activities and create value in the business. The entity’s equity investors capitalize the entity at a level sufficient to achieve its business purpose.

Which party would absorb the variability of the entity?

Analysis

In this simple example, only the equity investors absorb the variability of the fair value of the entity’s net assets. The entity’s assets and other contractual arrangements create variability to the results of the entity’s activities (i.e., the value of the business). The equity investors share in the value of the business positively (i.e., when the activities generate returns greater than expected) or negatively (i.e., when the activities generate returns less than expected).

EXAMPLE CG 3-2

Identifying variable interests

An entity’s primary activities involve the manufacture and sale of furniture. The entity purchases supplies and/or services from vendors, employees, and other parties to conduct its activities and create value in the business. The entity’s equity investors capitalize the entity at a level sufficient to achieve its business purpose.

The entity has decided to finance the acquisition of a new manufacturing facility through a subordinated loan from a third-party bank.

Which parties hold a variable interest?

Analysis

The loan does not create variability in the value of the business—rather, the new manufacturing facility does, as the incremental cash inflows to the entity attributable to the facility will vary based on business conditions. As a creditor, the bank is exposed to the risks and uncertainties of the entity’s

activities. The bank and the equity investors stand to lose or gain from changes in the value of the business, and thus they each have a variable interest in the entity.

3.2 ***“By design” approach—determining an entity’s variable interests***

Subsequent to the release of the VIE guidance in 2003, diversity in practice developed in determining whether certain contracts should be considered creators of variability or, conversely, absorbers of variability (i.e., variable interests). Much of this diversity stemmed from different views regarding the role played by certain derivatives, particularly interest rate swaps and foreign currency derivatives. In determining whether these contracts (as well as certain cash instruments) were variable interests, some believed that only those items that absorbed variability resulting from changes in the entity’s cash flows (cash flow variability) should be considered variable interests, while others believed that those instruments that absorbed changes in the entity’s fair value (fair value variability) should also be considered variable interests. These different viewpoints fostered diversity in practice with respect to identifying the risks associated with an entity (i.e., the entity’s variability) and evaluating which party absorbed those risks.

The FASB staff responded to this diversity in practice by issuing guidance that indicates that, as the first step in its consolidation analysis, a reporting entity should carefully analyze an entity’s design. The goal of this analysis is to determine the variability that the entity was designed to create and distribute to its interest holders. This evaluation affects not only the determination of which interests are variable interests in the entity, but also whether the entity is considered a VIE, and which party, if any, is the primary beneficiary of the VIE.

In many instances, it will be evident what variability an entity was designed to create and distribute to its interest holders. The analysis may not be so clear-cut in other cases. In any event, the “by design” model is intended to provide a framework that facilitates more consistent identification of an entity’s “variability” and thus, by extension, more consistent application of the VIE model. ASC 810-10-55-55 through ASC 810-10-55-86 provides eight examples that illustrate how to apply this guidance.

The “by design” model in ASC 810-10-25-22 through ASC 810-10-25-36 describes a two-step process for determining which variability should be considered in the assessment of an entity’s variability. The two-step process is as follows:

ASC 810-10-25-22

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

- a. Step 1: Analyze the nature of the risks in the legal entity (see paragraphs 810-10-25-24 through 25-25)
- b. Step 2: Determine the purpose(s) for which the legal entity was created and determine the variability (created by the risks identified in Step 1) the legal entity is designed to create and pass along to its interest holders (see paragraphs 810-10-25-26 through 36).

ASC 810-10-25-23 clarifies that, during this initial analysis, all instruments and contractual arrangements to which an entity is a party should be considered, and variability may be measured using methods that consider potential changes in cash flows and fair value of the entity.

ASC 810-10-25-23

For the 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.

3.2.1 “By design” approach—step 1: identify the risks of the entity

Step 1 of the “by design” model is generally a straightforward exercise—its objective is to identify all of the risks of the entity. ASC 810-10-25-24 cites the following examples of possible risks to which an entity may be subject.

ASC 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.

3.2.2 “By design” approach—Step 2: variability created to pass along

The purpose of Step 2 is to identify which of the risks identified in Step 1 create variability and thus are relevant to the assessment of an entity’s variability. Under the “by design” model, the relevant risks are those that the entity was designed to pass along to variable interest holders, as outlined in ASC 810-10-25-25.

ASC 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.

ASC 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.

In performing Step 2 of the "by design" model, an entity's governing documents, marketing materials, and terms of all other contractual arrangements should be examined to determine the variability that the entity was designed to create, taking into account the risks identified in Step 1.

When evaluating the risks the entity was designed to create and pass along to its interest holders, we believe that if a reporting entity creates certain risks in an entity, it generally cannot have a variable interest that absorbs those same risks.

To assist financial statement preparers, ASC 810-10-25-30 highlights factors that should be considered when identifying the variability that the legal entity is designed to create and pass along to its interest holders. The considerations relate to the following:

- Terms of the interests issued
- Subordination of the interest
- Certain interest rate risk
- Certain derivative instruments

Each of these considerations is discussed below.

3.2.3 "By design" approach—terms of the interests issued

ASC 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.

If the interest transfers risk and/or return of the entity's assets or operations to the holder of the interest, this is a strong indicator that the interest is a variable interest.

ASC 810-10-55-172 through ASC 810-10-55-181 provides an example (Case G) of the application of this concept involving a property lease entity. In that example, an entity is established with funding in the form of a five-year fixed-rate note and equity so that it can acquire property. The property is leased under a five-year lease to a lessee that has provided a residual value guarantee for the expected future value of the property at the end of five years. Because the residual value guarantee effectively transfers substantially all of the risks of the underlying property, there is a strong indication that the residual value guarantee is a variable interest. In other words, the residual value guarantee would be a variable interest because it absorbs the variability that the entity is designed to create.

The determination of whether an interest is a variable interest should not be based solely on the legal or accounting designation. Rather, the assessment should be based on whether the interest was designed to transfer risk to the interest holder, regardless of its accounting or legal treatment. This concept is illustrated in Example CG 3-3 and Example CG 3-4.

EXAMPLE CG 3-3

Interest obtained from a transaction that fails sale accounting

Assume that a reporting entity legally sells (transfers) a group of whole loans to a single-purpose securitization trust in return for cash, a beneficial interest in the trust entity (certain pass-through certificates issued by the trust), and a noncontingent fixed-price call option on the loans transferred.

Notwithstanding the sale of the loans' legal title to the trust, the existence of the fixed-price call results in the transfer failing sale accounting under ASC 860, *Transfers and Servicing* (ASC 860). As a result, the transfer must be accounted for as a secured borrowing by both parties (i.e., the transferor borrowed the proceeds from the transferee). The transferor continues to report the legally transferred loans on its balance sheet, along with a liability corresponding to the cash received. The transferor entity does not recognize the beneficial interest in its financial statements.

Does the transferor entity hold a variable interest in the securitization trust?

Analysis

The transferor entity's analysis should focus on the design of the securitization trust, the terms of all relevant agreements, and the risks intended to be passed on to its variable interest holders. The accounting characterization of the loan portfolio's transfer, and the corresponding financial reporting of the exchange by both parties, should not affect this evaluation.

In this instance, the securitization trust legally owns the portfolio of loans, and it can be inferred that the design of the trust entity is to pass along the risks of those loans to its beneficial interest holders. For purposes of applying the VIE model, the trust's assets consist of the acquired loans—not a receivable from the transferor. Thus, the holders of the trust's pass-through certificates, including the transferor, should be considered to hold a variable interest in the trust—even though, in the transferor's case, the certificates are not recognized on its balance sheet (because of applying the "failed-sale" reporting model to the exchange).

The noncontingent fixed-price call option also exposes the transferor to changes in the fair value of the transferred loans. The transferor should therefore determine whether the call option represents a

variable interest in specified assets, or an additional variable interest in the trust entity. If the fair value of the transferred loans represents greater than 50% of the trust entity's total assets, the call option represents an additional variable interest in the trust entity. Refer to CG 3.7 for further discussion on variable interests in specified assets when the transferred loans represent less than 50% of the trust entity's total assets.

EXAMPLE CG 3-4

Variable interest in lease arrangements

A reporting entity leases one asset from an entity that holds only two assets. The reporting entity has a fixed-price purchase option to acquire the asset. The fair value of the leased asset is more than 50% of the fair value of the entity's total assets. The lease qualifies as a finance lease.

Does the reporting entity have variable interest in the lessor entity?

Analysis

The fixed-price purchase option should be viewed as a variable interest in the entity since the fair value of the leased asset represents more than 50% of the fair value of the entity's total assets. If the fair value of the leased asset represented less than 50% of the fair value of the entity's total assets, the contract would be a variable interest in specified assets (see CG 3.7).

If the entity were considered a VIE, the reporting entity could be required to assess consolidation of the VIE under the power and losses/benefits criteria. The results achieved by consolidating the entire entity (i.e., recording both assets and the liabilities of the VIE) could be substantially different from those that would result from applying finance lease accounting to only the leased asset under ASC 842.

In contrast, the reporting entity would not have a variable interest in the entity if it borrowed funds from the entity to acquire a leased asset from a third party. Similar to Example CG 3-2, a loan from the entity would create, not absorb, variability within the entity as the borrowing would expose the entity to the reporting entity's credit risk and potentially interest rate risk.

3.2.4 “By design” approach—substantive subordination of interests

For entities that issue both senior and subordinated interests, the absorption of risks by substantive subordinated interests is a strong indicator of the variability that the entity is designed to create.

Excerpt from ASC 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.

When considering whether a subordinated interest is substantive, we believe that all relevant facts and circumstances should be considered, including:

- The interest’s entitlement to cash flows and its relative placement in the contractual priority of payments (“waterfall”) that governs the distribution of cash flows to lenders and investors of the entity
- Yields (interest rates) of the various interests issued
- Amount and size of the subordinated interests to all other interests issued (i.e., its size in relation to the total capitalization of the entity)
- Credit ratings of the interests issued
- The nature of the investors (institutional or retail) and how the instrument was marketed which may provide insight into the risk of an investment relative to other interests in the entity

3.2.5 **“By design” approach—certain interest rate risk**

Whether a reporting entity should consider the variability of an entity that is attributable to interest rate risk is addressed in ASC 810.

ASC 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 variability that the legal entity was designed to create and pass along to its interest holders.

Interest rate risk should be excluded from variability if the entity was not designed to pass along interest rate risk to its interest holders. However, if an entity holds fixed-rate investments and expects to actively manage the portfolio by selling prior to maturity, the entity may be designed to pass along interest rate risk to its interest holders. The cash received upon redemption will vary based on fluctuations in the interest rate.

Example CG 3-5 may be helpful in applying this guidance.

EXAMPLE CG 3-5

Variability created by a bond investment expected to be held to maturity

Consider an entity established to invest in a fixed-rate bond that is expected to be held to its maturity, which is funded with matching maturity fixed-rate debt.

Should the entity’s variability include interest rate risk?

Analysis

No. The entity's variability arises from its investment in the fixed-rate bond, which exposes the entity to the issuer's credit risk. As the issuer of the fixed-rate bond's credit risk changes, so too will the fair value of the entity's net assets. The entity's variability would not, however, include variability caused by changes in interest rates since there is no planned sale of the fixed-rate bond.

Case A through Case D provided in ASC 810-10-55-55 through ASC 810-10-55-70 illustrate how to consider interest rate risk variability in the context of VIEs that hold financial assets.

3.2.6 “By design” approach—certain derivative instruments

ASC 810-10-25-35 to ASC 810-10-25-36 provide guidance for assessing whether certain derivative contracts create or absorb variability.

ASC 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.

ASC 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 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 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.

This guidance does not constitute a “scope exception” for derivatives, but rather simplifies the analysis for many common derivatives (e.g., certain market-based interest rate swaps and foreign currency contracts).

First, the contract should be analyzed to determine whether it meets the characteristics of a derivative under ASC 815, *Derivatives and Hedging* (ASC 815). We believe that those contracts that meet the characteristics of a derivative are eligible for consideration under the “by design” guidance, regardless of whether the contract qualifies for one or more of the scope exceptions in ASC 815-10.

Next, an evaluation of the contract's underlying must be made to determine whether it is based on an observable market rate, price, index of prices or rates, or other market observable variable(s) (including

the occurrence or nonoccurrence of a specified market observable event). ASC 815-10-15-88 through ASC 815-10-15-91 provide additional guidance on what constitutes an underlying of a derivative. Generally, normal market contracts such as SOFR-based interest rate swaps, foreign currency contracts, and commodity futures have market observable variables.

Finally, whether the derivative contract is senior in priority (i.e., senior in the entity's priority of payments "waterfall") relative to other interest holders in the entity should be considered. We believe that if the derivative is at least *pari passu* with the most senior interest(s) issued by the entity, this condition would be met.

However, the "by design" guidance specifies that even if the two conditions discussed above are met, a derivative may still be a variable interest as opposed to a creator of variability, if the changes in the value of the instrument are expected to offset all, or essentially all, of the risk or return related to the majority of the assets or operations of the entity. In these cases, the design of the entity must be further evaluated. If the entity was designed to create and pass along specific risks to the derivative counterparty, the derivative would likely be considered a variable interest. Example CG 3-6 illustrates this assessment.

EXAMPLE CG 3-6

Evaluating whether a "receive-variable, pay-fixed" interest rate swap agreement is a variable interest

An entity's only asset is a fixed-rate bond that is funded with variable-rate liabilities. The entity enters into a "receive-variable, pay-fixed" interest rate swap, which allows the entity to pay a fixed interest rate in return for receiving a variable interest rate.

Is the interest rate swap agreement a variable interest in the entity?

Analysis

Yes. This swap arrangement synthetically creates a variable-rate asset, which will absorb the interest rate exposure from the fixed-rate bond. As the bond is the only asset of the entity, it may be considered that the entity was designed to pass along the bond's interest rate risk to the interest rate swap's counterparty.

Refer to CG 3.3.5 for a further discussion of derivatives and embedded derivatives.

3.3 Examples of variable interests

Variable interests are not limited solely to equity investments.

Excerpt of definition from ASC 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.

The following are examples of common arrangements that may be variable interests:

- Equity interests
- Beneficial interests
- Debt instruments
- Guarantees
- Put options
- Call options
- Management contracts
- Service contracts
- Franchise arrangements
- Leases
- Cost-plus arrangements
- Technology licenses, royalties, and other similar arrangements
- Collaborative R&D arrangements
- Forward contracts
- Interest rate swaps and total return swaps
- Derivatives
- Residual value guarantees
- Purchase options

ASC 810-10-55-16 through ASC 810-10-55-41 provide guidance that may be helpful when determining whether common contractual and ownership arrangements are variable interests. Certain of the items listed above are discussed in further detail below. It is worth noting that the following guidance focuses on how to apply the concept of a variable interest to various instruments and contracts.

3.3.1 Variable interests—equity investments

The most obvious variable interests are equity investments. Equity investors provide capital to an entity in exchange for an ownership interest that exposes the investors to the entity's potential losses and potential returns. Therefore, they absorb the entity's economic risks and rewards.

ASC 810-10-55-22 clarifies an important point; just because an equity investment is not at risk does not necessarily mean that the investment is not a variable interest. An equity investment that is not at risk may nevertheless absorb an entity's expected losses and receive its expected residual returns (see CG 4.3).

Example CG 3-7 evaluates whether an interest in a trust preferred security is a variable interest.

EXAMPLE CG 3-7

Evaluating whether an interest in trust preferred securities is a variable interest

Under a typical trust preferred securities structure, a sponsor creates a special purpose vehicle (a trust). The sponsor purchases 100% of the residual interest in the trust, which represents 3% of the overall equity of the trust.

The trust issues long-term, date-certain, redeemable preferred securities to investors. The trust then lends the proceeds of the preferred securities issuance to the sponsor. The sponsor issues debentures

as evidence of its indebtedness to the trust (the trust's only asset), and the sponsor issues a full and unconditional guarantee to the investors in the trust preferred securities.

The trust preferred securities have a fixed interest rate with the entire principal due at maturity. The securities are also callable after a specified period of time. In addition, the sponsor has the right to remove the trustee.

Trust preferred securities may be advantageous since the securities often receive partial equity credit by rating agencies and favorable regulatory capital treatment.

Does the sponsor have a variable interest in the trust?

Analysis

No. The sponsor would not have a variable interest in the trust. From the sponsor's perspective, neither the residual interest held, nor the loan payable to the trust, would be considered variable interests.

The loan receivable from the sponsor is the only asset of the trust, and it is the obligation of the sponsor to pay the contractual interest and principle payments to the trust. The loan receivable is not a variable interest since the loan receivable is an asset of the trust and it creates variability (the credit risk of the sponsor) that is passed on to the variable interest holders. While the sponsor's residual equity interest in the trust is exposed to variability in the form of credit risk, that variability is created by the sponsor entity itself. We believe that an interest held by a reporting entity would not be a variable interest if that interest only absorbs variability created by the same reporting entity.

In addition, the fact that a sponsor has unconditionally guaranteed the trust preferred securities is irrelevant, since the sponsor is guaranteeing its own obligations.

3.3.2 Variable interests—debt instruments and beneficial interests

A reporting entity may provide debt financing to an entity in exchange for fixed or variable returns. Because an entity's activities and the resulting fluctuations in the fair value (or cash flows) of the entity may affect the ultimate collectability of these returns, debt instruments absorb variability. As a result, virtually all debt instruments are variable interests.

ASC 810-10-55-23

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

As the level of priority with respect to returns of investments increases, the variability associated with those returns diminishes. Senior debt (e.g., investment grade debt) and senior beneficial interests (usually with fixed interest rates or other fixed returns) nevertheless are variable interests—even

though the degree of variability absorbed by senior interests may be reduced by subordinated interests and the relative credit quality of the entity. ASC 810-10-55-24 elaborates on these points.

ASC 810-10-55-24

Any of a VIE's liabilities may be variable interests because a decrease in the fair value of a VIE's assets could be so great that all of the liabilities would absorb that decrease. However, senior beneficial interests and senior debt instruments with fixed interest rates or other fixed returns normally would absorb little of the VIE's expected variability. By definition, if a senior interest exists, interests subordinated to the senior interests will absorb losses first. The variability of a senior interest with a variable interest rate is usually not caused by changes in the value of the VIE's assets and thus would usually be evaluated in the same way as a fixed-rate senior interest. Senior interests normally are not entitled to any of the residual return.

3.3.3 Variable interests—guarantees, put options, similar obligations

Options purchased/exercisable by the entity/options written by the reporting entity

Entities sometimes seek to offset (hedge) the potential risks associated with changes in the fair value of one or more of their assets or liabilities by entering into arrangements that transfer some or all of that risk to other parties. In addition, guarantees of the value of assets or liabilities, written put options on the assets of an entity, and other similar arrangements are examples of interests that may absorb the potential variability related to the entity's operations and assets. In many cases, the writer of the contract will absorb at least some portion of the expected losses of the entity.

ASC 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.

As discussed below, the analysis of a guarantee can differ, depending on whether the underlying or reference obligation is an asset or liability of the entity. That distinction can have major implications on the consolidation evaluation.

A guarantee of the value of an entity's assets must first be evaluated to determine whether the contract should be considered a variable interest in the entire entity or, alternatively, should be viewed as a variable interest in the underlying, specified assets. The latter concept, known as "variable interests in specified assets," is described in further detail in CG 3.7. If a guarantor has guaranteed the value of a specific asset of the entity, that guarantee is a variable interest in the entire entity only if the fair value of the guaranteed assets constitutes a majority (greater than 50%) of the fair value of the entity's total assets.

When analyzing a guarantee of an entity's obligations, the foregoing distinction (interest in an entity versus an interest in the underlying guaranteed item) is not relevant. These contracts are analyzed exclusively as potential variable interests in the entity, as discussed in more detail below.

Similar to a guarantee, a fixed-price put option written by a reporting entity and purchased by an entity is usually a variable interest. The entity (that purchased the put) receives the right, but not the obligation, to put (sell) the referenced item to the reporting entity at a fixed-price (i.e., the strike price) during a specified period or on a specified date. When an entity purchases a put option, it receives the right to transfer the potential risk of loss on the underlying item to the writer of the put (i.e., the option writer absorbs the risk of loss on the asset's value).

Typically, in these arrangements, the purchaser of a put option pays a premium to the writer for its rights under the contract (i.e., the price of protection on the underlying asset). That amount is influenced by factors such as the duration of the option, the difference between the exercise price and the fair value of the underlying assets, price volatility, and other characteristics of the underlying assets. In exchange, the writer of the put is exposed to the risk of loss if the fair value of the underlying assets declines, but profits only to the extent of the premium received—as, presumably, if the underlying assets increase in value over the put's life, the holder of the option will not exercise it.

If a reporting entity has guaranteed a liability of an entity (effectively, a written put option), that guarantee is a variable interest in the entity. This is because the guarantee is protecting holders of other variable interests from suffering losses. For example, a financial guarantor of beneficial interests issued by a securitization entity has a variable interest in that entity. When assessing such financial guarantee of liabilities of the entity, it is important to note that they are always variable interests, regardless of the design of the entity.

If the entity has the option to buy an asset (i.e., a call option) from the option writer at a specified price, this contract usually is not a variable interest in the entity, as the option is creating variability for the entity.

Options written by the VIE

ASC 810-10-55-26

If a 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).

If a VIE is a writer of a put option, the purchaser of this option has the right to sell an asset or its investment back to the VIE. The contract transfers risk of loss from the purchaser of the option to the VIE, and therefore creates variability for the VIE. As a result, such contracts are not generally viewed as variable interests. The variability resulting from these arrangements must be considered in determining the entity's economic risks and rewards. This is also consistent with the example in the "by design" guidance (Case E; ASC 810-10-55-71 through ASC 810-10-55-74), which concludes that the credit default swap written by the VIE should be considered a "creator" of variability.

If the entity writes a call option on its assets, the purchaser of this option has the right to buy an asset of the entity at a specified price. This contract is a variable interest in the asset as it absorbs variability in the asset, and it may be a variable interest in the VIE if the underlying asset represents more than

50% of the fair value of the VIE's total assets. If the underlying asset represents less than 50% of the fair value of the VIE's total assets, the contract would be a variable interest in specified assets (see CG 3.7).

Options written/purchased among reporting entities

A reporting entity may write options to, or purchase options from, a counterparty with respect to an investee's assets/liabilities/equity (e.g., the right to purchase a joint venture partner's equity interest in the venture). These options are not direct variable interests in the investee entity since they are not related to a specific contract with the investee entity.

Even though the investee entity is not the counterparty to such options, they do alter the cash flows with respect to the variable interests held by the parties that entered into the option arrangement. Therefore, these arrangements may impact the consolidation analysis of the parties that entered into the option agreement. Example CG 3-8 illustrates this concept.

EXAMPLE CG 3-8

Evaluating whether a purchased call option is a variable interest when the investee entity is not the direct counterparty to the option

A venture is created whereby Company A and Company B each contributes \$50 million in cash in exchange for a 50% equity ownership. Company A and Company B each has equal representation on the venture's board of directors and decisions require a unanimous vote. Company A has an option to purchase Company B's entire equity interest for \$60 million exercisable two years from the venture's inception date.

Is the option to purchase Company B's equity interest a variable interest for Company A at inception under ASC 810?

Analysis

Yes. The option is a variable interest since it is exercisable at a fixed-price and, as a result, Company A absorbs the positive variability from changes in the fair value of the venture.

Conversely, if the strike price of the option is at "true" fair value of the underlying, then such an option is not a variable interest—since the option strike price fluctuates with the change in the fair value of the venture. Caution should be exercised with respect to fair value call options to ensure that the definition of fair value in the agreement is consistent with "true" fair value. Some agreements may define formulas for the strike price intended to approximate fair value or expectations of fair value (e.g., formulas based on trailing earnings before interest, depreciation and taxes). In many cases, these formulas may result in calculated amounts that are close to fair value, but do not represent fair value. If so, the option may be a variable interest.

3.3.4 Variable interests—forward contracts and supply arrangements

The determination of whether forward contracts or supply agreements are variable interests involves consideration of the design of the entity. The FASB has provided only high-level guidance to assist in these assessments.

ASC 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.

ASC 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.

The contract first should be evaluated to determine whether it contains a lease. If the contract contains a lease, then refer to CG 3.5 for a further discussion of evaluating leases to determine if they are variable interests. Any remaining non-lease elements should also be analyzed to determine if they are variable interests.

If the contract does not contain a lease, the contract should be evaluated to determine whether it constitutes a derivative. If the forward contract meets the characteristics of a derivative under ASC 815-10, the contract should be evaluated considering the strong indicators for derivatives in the "by design" model (see CG 3.2).

For those forward contracts and supply arrangements that are not determined to be creators of variability according to the strong indicators for derivatives, a careful analysis of the terms of the contract and the design of the entity should be performed. The pricing of a contract (e.g., fixed price, fixed formula, cost plus) might affect the determination of whether the contract is a variable interest. If the purchase agreement contains any off-market terms, it may indicate that the arrangement is a variable interest, particularly if it provides financing or other support to an entity.

ASC 810-10-55-81 through ASC 810-10-55-86 provide an example of 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. However, we believe that forward contracts are some of the most difficult interests to evaluate under the VIE model. Whether or not 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.

A forward or supply contract to buy assets at a fixed price (or fixed formula) will absorb the variability in the fair value of those assets. A contract that has certain types of a variable pricing mechanism (e.g., cost plus) may also be a variable interest. However, a variable exercise price does not automatically lead to a conclusion that such forward contracts are variable interests in the entity. Consideration of the risks associated with the underlying entity and its design must be considered in making this determination.

If a forward contract relates to specified assets that represent 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 CG 3.7).

Example CG 3-9 illustrates how a purchase and sale agreement may create a variable interest.

EXAMPLE CG 3-9

Purchase and sale agreement with a non-refundable deposit

Company A enters into a fixed-price purchase and sale agreement with Company X under which Company A will buy from Company X land and a building. Company X's sole assets are the land and the building that will be sold under the agreement. As part of the agreement, Company A is required to pay a non-refundable deposit to Company X. Company A also has the right to terminate the contract, subject to the loss of its deposit.

Does Company A have a variable interest in Company X arising from the purchase and sale agreement?

Analysis

Yes. Company A will absorb some level of variability in the fair value of the land and the building as a result of entering into the purchase and sale agreement with Company X and providing a non-refundable deposit. Even if Company A has the unilateral right to cancel the agreement, it still has economic upside because the agreement to purchase the land and the building is at a fixed price.

3.3.5 Variable interests—other derivative instruments

ASC 810-10-55-29 through ASC 810-10-55-31 provide additional implementation guidance to assist reporting entities in evaluating whether a derivative instrument is a variable interest. This guidance augments the framework for analyzing these contracts (discussed in CG 3.3.3 and CG 3.3.4) and should be considered from that perspective.

ASC 810-10-55-29

Derivative instruments held or written by a VIE should 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.

ASC 810-10-55-30

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

ASC 810-10-55-31

Some assets and liabilities of a VIE have embedded derivatives. For the purpose of identifying variable interests, an embedded derivative that is clearly and closely related economically to its asset or liability host is not to be evaluated separately.

Determining whether a derivative contract is a variable interest may involve significant judgment. This analysis should take into account the entity's activities and design, and the role the derivative is intended to play in that context. For example, is the contract designed to hedge other exposures of the entity or, conversely, is it intended to expose the entity to incremental risks. As discussed in ASC 810-10-55-31, an embedded derivative that is not clearly and closely related to its asset or liability host should be evaluated to determine if it is a variable interest.

When examining debt instruments, the following embedded derivatives would not typically be evaluated separately as variable interests:

- Call options
- Put options
- Caps or floors on interest rates
- Other interest rate indexes
- Credit-sensitive payments or indexes to the issuer's creditworthiness

In these cases, the economic characteristics of the embedded derivatives typically are clearly and closely related to the debt instrument. However, in instances where the relevant terms introduce significant leverage or are based on factors that are not economically related to the debt instrument, the embedded feature would likely be considered other than clearly and closely related, in which case the feature should be examined to determine whether it is a variable interest. This conclusion would apply in situations where the debt includes a derivative indexed to one of the following:

- Another party's credit (that is, a party other than the instrument's issuer)
- Movements in commodities
- Equity prices (e.g., the S&P 500 index)

3.3.6 Variable interests—assets of the entity**ASC 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.

Examples of assets that may be variable interests are derivatives, purchased guarantees, and similar contracts. In addition, an asset may have an embedded derivative feature that might be considered a variable interest, as discussed in ASC 810-10-55-32.

3.3.7 Variable interests—license, royalties, and similar arrangements

Generally, licenses, royalties, and similar arrangements are linked to an entity's performance indicators (e.g., revenue, EBITDA). As a result, such contracts typically obligate the entity to make payments in amounts that correspond, in varying degrees, to changes in the fair value of the entity's net assets. As such, these arrangements may absorb variability in the entity and, as such, may represent variable interests. A reporting entity should consider the design of the entity, including whether the license or similar arrangement was intended to create variability that is passed on to other interest holders or to absorb variability of the entity. Additionally, a reporting entity should assess whether a license or similar arrangement that absorbs variability is a variable interest in specified assets or a variable interest in the entity as a whole. See CG 3.7 for further discussion on variable interests in specified assets.

3.4 Variable interests—decision maker or service provider fees

ASC 810 defines a decision maker as 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. Determining whether the fees paid to an entity's decision maker constitute a variable interest in the entity can be one of the most challenging exercises required under ASC 810's consolidation model. The assessment is particularly complex if parties related to the decision maker also hold interests in the entity being analyzed. Moreover, the conclusion reached with respect to this matter has potentially significant "knock-on" ramifications for other key judgments, including:

- Concluding whether the entity is a VIE, specifically, whether the entity's equity holders at risk have the power to direct the activities of the entity that most significantly impact its economic performance (as discussed in CG 4.1)
- If the entity is a VIE, concluding whether the decision maker is its primary beneficiary

As such, particular care must be exercised when performing this evaluation.

The consolidation model incorporates various tests and conditions to determine whether fees paid to a decision maker or a service provider should be considered a variable interest in an entity. ASC 810-10-55-37 prescribes the current framework for making this assessment.

Excerpt from ASC 810-10-55-37

Fees paid to an entity's decision maker(s) or service provider(s) are not variable interests if all of the conditions below 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 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 2015-02.
- f. Subparagraph superseded by Accounting Standards Update 2015-02.

Application of these conditions is discussed below.

For ease of reference, unless the context indicates otherwise, the term "decision maker" is intended to encompass both a decision maker and any other service providers.

3.4.1 Variable interests—assessing “commensurate” and “at market”

To be considered indicative of a fiduciary relationship, the decision-making fee arrangement must be arms-length and contain customary terms and conditions (“at market”) and represent compensation that is considered fair value for the services provided (“commensurate”).

- *Assessing the “commensurate” condition*—We believe that the purpose of this condition is to identify arrangements that provide a decision maker with a significant off-market fee element and/or that are structured in a manner that suggests the fee is inconsistent with the decision maker's role.
- *Assessing the “at market” condition*—Unique provisions or terms seemingly at odds with market convention may indicate that the decision maker is serving in a manner inconsistent with a fiduciary role or relationship.

To determine whether its fee arrangement is at market and commensurate, a reporting entity may consider the following factors, among other items:

- Is the entity owned by substantive third party investors?

If the entity is owned by substantive third party investors, that fact may provide persuasive evidence that the arrangement reflects arms-length, market-based terms and conditions.

We believe it is reasonable to assume in many instances that independent investors would not invest in an entity that is counterparty to a services agreement that contains off-market or non-customary terms and conditions, or a fee structure that is above-market.

- Does the decision maker hold other variable interests (beyond its fee arrangement) that are unique as compared to variable interests held by the entity's other investors?

Decision makers often voluntarily or involuntarily make co-investments in entities they manage so that their interests are aligned with the entity's investors. If these other interest(s) are unique in comparison to the variable interests held by the entity's third-party investors, we believe it would be inappropriate to qualitatively conclude that the arrangement is “at market” and

“commensurate.” For example, a security with economic rights and privileges different from other third-party investors may be unique. We believe normal decision makers that are acting in an agency capacity generally do not hold variable interests that differ from those held by the entity’s other independent investors.

If the legal entity being evaluated is not owned by substantive third party investors and/or the decision maker holds another unique variable interest, we believe it would be inappropriate to qualitatively conclude that the decision-making fee is “at market” and “commensurate.” In those situations, additional analysis would be required to support this assertion. This analysis could include an evaluation of other fee arrangements involving other third-party decision makers for the same or similar services.

Question CG 3-1 addresses whether servicing arrangements in asset-backed securitizations that include “servicing advances” and “clean up calls” meet the “at market” condition to not be considered a variable interest.

Question CG 3-1

Do servicing arrangements that include “servicing advances” and “clean up calls” meet the “at market” condition to not be considered as a variable interest?

PwC response

Yes, we believe that servicing contracts that include the right to provide “servicing advances” and the right to exercise “clean up calls” are customary in many asset-backed securitization arrangements and would generally meet the “at market” condition to not be considered as a variable interest.

3.4.1.1 Contractual features that expose decision makers to risk of loss

When evaluating the decision-making fee arrangement, if there is any fee or related obligation embedded within the service contract that exposes the decision maker to a risk of loss as described in ASC 810-10-55-37C, the decision-making fee would be excluded from applying the exception in ASC 810-10-55-37 and would therefore be considered a variable interest in the entity it to which it provides services.

ASC 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.

In other words, if there are other features or obligations embedded in the servicing contract, beyond those of providing services to direct the activities of the entity, which would expose the decision maker to a risk of loss of the entity, the decision-making fee would be considered a variable interest. This evaluation does not consider the level of significance and/or likelihood of the exposure to loss.

In contrast, as discussed in CG 3.4, if the decision maker has other separate interests or arrangements with the VIE, in addition to the contract to provide services (i.e., not embedded in the service contract), it will evaluate whether those separate interests individually, or in the aggregate, would absorb/receive more than an insignificant amount of the VIE's expected losses/residual returns, as is required under ASC 810-10-55-37(c). If they do not, the decision maker fee would not be considered a variable interest in the entity. That evaluation will include any fees which may also have the characteristics as those mentioned in ASC 810-10-55-37C within those separate interests or arrangements.

3.4.2 Variable interests—assessing other interests in the entity

ASC 810-10-55-37(c) requires a decision maker to consider the nature and extent of other interests it holds in the entity (interests other than its fee). Holding these “other economic interests” in the entity that result in the decision maker absorbing more than an insignificant amount of variability will cause the decision-making fee arrangement to be a variable interest. In addition, certain related party interests must be considered in this assessment.

The assessment of whether the decision maker's collective other interests expose it to more than insignificant variability is both qualitative and quantitative, and requires the exercise of judgment.

3.4.2.1 Indirect interests held through related parties

Indirect variable interests held through related parties are considered on a proportionate basis, including those interests held by related parties under common control. This treatment is also consistent with how a decision maker considers indirect variable interests when performing the primary beneficiary assessment. Refer to CG 5.6 for further discussion and an example.

The FASB has acknowledged that there is no definition of “common control” in the codification.

Excerpt from BC69 in ASU 2015-02

Current GAAP uses the term common control in multiple contexts, and the term is not defined in the Master Glossary. Therefore, for purposes of evaluating the criteria in paragraphs 810-10-25-42, 810-10-25-44A, and 810-10-55-37D, the Board's intent was for the term to include subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.

Refer to BCG 7.1.1 for information about assessing whether common control exists.

ASC 810-10-55-37D articulates the framework that a decision maker must apply when evaluating indirect interests held through related parties.

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

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

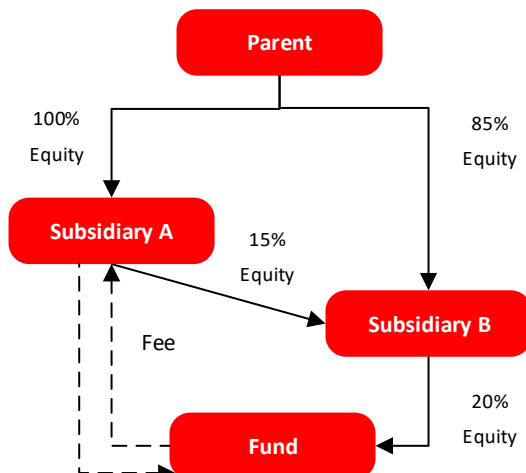
For purposes of evaluating the conditions in paragraph 810-10-55-37, the quantitative approach described in the definitions of the terms expected losses, expected residual returns, and expected variability is not required and should not be the sole determinant as to whether a reporting entity meets such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

To have an indirect variable interest, a decision maker must have a direct variable interest in a related party that, in turn, has a direct and/or indirect variable interest in the entity being evaluated for consolidation. Although this requirement may appear straightforward, the analysis will become more complex when the economic interests held deviate from "plain vanilla" equity interests held by the decision maker in the related party, and/or by the related party in the entity being evaluated for consolidation. For example, the decision maker may hold a convertible preferred equity investment in the related party that in turn holds a debt investment in the entity being evaluated for consolidation.

Example CG 3-10 illustrates the determination of whether a decision-making fee is considered a variable interest in a VIE.

EXAMPLE CG 3-10**Determining whether a decision-making fee is considered a variable interest in a VIE**

Subsidiary A and Subsidiary B are under common control of Parent. Subsidiary A has a 15% equity interest in Subsidiary B. Subsidiary A entered into a management contract with a fund, determined to be a VIE, whereby it receives a management fee that is considered at market and commensurate. Subsidiary B has a 20% equity interest in the fund.



Is Subsidiary A's management fee a variable interest in the VIE?

Analysis

No. Subsidiary A's indirect interest in the VIE on a proportionate basis results in a 3% ($15\% \times 20\%$) economic interest in the fund, which Subsidiary A would likely conclude is not more than insignificant. Therefore, its management fee would not be a variable interest, and Subsidiary A would be considered to be operating in an agency capacity. Even though the management fee would not be a variable interest for purposes of Subsidiary A's financial statements, Parent would have a variable interest when assessing its indirect interest in the fund.

3.4.2.2 Consideration of employees and employee benefit plans

A decision maker's employees or employee benefit plans may hold variable interests in the entity being evaluated for consolidation by its decision maker. Although employees and employee benefit plans may be related parties of a decision maker, the decision maker need not consider those interests when evaluating criterion (c) in ASC 810-10-55-37 unless those employees or plans are being used to circumvent the VIE guidance more generally. See excerpt from ASC 810-10-55-37D above which clarifies this matter.

ASC 810-10-55-37D does not specifically state whether the portion of any interest held by a decision maker's employees or employee benefit plan that has been financed by the decision maker should be deemed an indirect interest attributable to the decision maker. In contrast, for purposes of the primary beneficiary analysis, ASC 810-10-25-42 explicitly states that a decision maker should treat the portion of any employee interests that it has financed as an indirect economic interest.

In our view, if a decision maker contributes to its employee benefit plans, and the employee benefit plans in turn make independent decisions to invest in an entity, we believe the interests held by the employee benefit plans should not be attributed to the decision maker in connection with its evaluation of potential "other economic interests" held by related parties under ASC 810-10-55-37D.

On the other hand, if a decision maker provides financing for a specific interest held by an employee or employee benefit plan as part of the design of the underlying entity, and that funding is atypical or inconsistent with past practice, those arrangements may be indicative of efforts to circumvent the

consolidation rules. If the facts and circumstances suggest that the arrangements were structured principally to achieve a desired accounting outcome, we believe that those financed interests should be attributed to the decision maker for purposes of assessing the “other economic interests” criterion.

3.4.2.3 *Evaluating “more than insignificant”*

ASC 810-10-55-37(c)’s “other economic interests” criterion requires the decision maker to assess the significance of its other economic interests in an entity. In that assessment, the decision maker should consider those interests’ relative exposure to the entity’s expected losses and relative entitlement to the entity’s expected residual returns. Each of these concepts is a defined term in the ASC Master Glossary. ASC 810-10-55-37D provides useful guidance regarding the application of these concepts.

Excerpt from ASC 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.

Judgment is required when assessing whether other economic interests held by (or attributed to) a decision maker absorb more than an insignificant amount of an entity’s expected losses or receive more than an insignificant amount of an entity’s expected residual returns. Although this assessment must still benchmark those interests against the entity’s expected losses and expected residual returns, it is clear from the foregoing excerpt that the FASB does not intend for this requirement to be demonstrated by detailed computational analyses. Rather, preparers are to exercise judgment in performing a qualitative assessment of the economics provided by any other interests they hold.

Additionally, “more than an insignificant amount” is not defined in the context of the consolidation model. However, the concept is intended to mean the same as “significant”—said differently, a “more than insignificant amount” does not imply or contemplate a threshold (or range) that falls somewhere between “insignificant” and “significant.” Although a “more than insignificant amount” cannot be reduced to a “bright line,” we believe that the interpretation of “more than insignificant” is a fairly low threshold and it is reasonable to view 10% or more as presumptively indicative of other interests constituting a “more than insignificant amount.”

When evaluating the significance of other economic interests held by (or attributed to) a decision maker relative to the entity’s anticipated variable returns, the following factors or indicators may be useful:

- The size of the interest relative to the overall capitalization of the entity
- The commercial reasons behind the decision maker’s ownership of those interests

For example, consider situations in which investments by the decision maker were made to support marketing of investments into the entity. In this case, it may indicate that the decision maker made such investment to signal to others that the decision maker is willing to put its own interests at risk. This may indicate that the decision maker is not acting as a fiduciary as it made the investment to demonstrate to the other investors that it has “skin in the game.”

- The risks and rewards of the variable interests held by the reporting entity relative to the overall economics of the structure
- The relative seniority of variable interests held by the decision maker

We believe that as a variable interest falls lower in the entity's priority of payments, the threshold at which the interest should be considered "more than insignificant" also drops.

As noted above, when assessing whether a decision maker's other economic interest is considered "more than insignificant," it should be considered against the entity's expected losses and expected residual returns, which by their definitions allow the consideration of probability. Consequently, if the reporting entity determines that it holds an interest in an entity that is more than insignificant, it will likely also meet the primary beneficiary "potentially significant economics" criterion in ASC 810-10-25-38A(b). As discussed in CG 5.5, the assessment of whether a reporting entity has a potentially significant economic exposure in the VIE does not allow consideration of probability, and thus, in practice, the "potentially significant" threshold in the primary beneficiary economics criterion is effectively lower than the "more than insignificant" threshold in the decision maker's other economic interest test.

3.4.3 *Reconsidering decision maker and service provider arrangements*

CG 5.1 describes reconsideration events to re-evaluate whether an entity is a VIE. The VIE model requires an ongoing reconsideration of whether a reporting entity is the primary beneficiary of a VIE due to changes in facts and circumstances. The VIE model does not specify whether the reassessment of a decision maker's arrangement as a variable interest should be based on specific reconsideration events (similar to reconsidering the status of a VIE), or should be carried out on a continuous basis (as is required for the primary beneficiary analysis). We believe that the decision about when to reassess the conclusion is a policy choice by the reporting entity.

Regardless of which policy is elected, the assessment should focus on events that would incentivize the decision maker to begin acting as a principal, or conversely, would suggest the decision maker is acting in an agency capacity, such as:

- Changes in the terms of the management or service provider arrangement
- The decision maker or service provider's acquisition or disposition of variable interests in the entity being evaluated for consolidation (either directly or through their related parties)

3.5 *Variable interests—leases*

Guidance on how to apply the VIE model to leases is found in ASC 810-10-55-39.

ASC 810-10-55-39

Receivables under an operating lease are assets of the lessor entity and provide returns to the lessor entity with respect to the leased property during that portion of the asset's life that is covered by the lease. Most operating leases do not absorb variability in the fair value of a VIE's net assets because they are a component of that variability. Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices may be variable interests in the lessor entity if they meet the conditions

described in paragraphs 810-10-25-55 through 25-56. Alternatively, such arrangements may be variable interests in portions of a VIE as described in paragraph 810-10-25-57. The guidance in paragraphs 810-10-55-23 through 55-24 related to debt instruments applies to creditors of lessor entities.

When evaluating whether a lease is a variable interest, reporting entities should consider, among other things, whether the lease is an operating lease, as well as whether there are other features that are designed to absorb the economic variability of a VIE. Further, embedded leases should also be assessed to determine whether they represent variable interests.

3.5.1 Variable interests—entity is the lessor

Lease receivables of the lessor entity are not variable interests. Rather, receivables from operating leases create variability in the entity's operations and fair value.

The following embedded features included in operating leases may be variable interests:

□ *Lessee purchase options*

A fixed-price or formula-based purchase option is a variable interest in the asset because it provides the holder of that option with the potential to purchase the asset at a price that is less than fair market value. Effectively, if the purchase option is exercised, the lessor entity's equity investors would not receive all of the asset's expected residual returns. If the purchase option were on assets that comprise less than 50% of the fair value of the lessor entity's total assets, the purchase option would not be a variable interest in the lessor entity as a whole; rather, it would be a variable interest in specified assets. Consideration should also be given to whether the purchase option, in combination with other interests, create a "silo" within a VIE. See CG 3.7 through CG 3.8 for further discussion on variable interests in specified assets and silos.

□ *Lessee residual value guarantees*

In many leasing arrangements, the lessee provides a residual value guarantee on the leased asset. A residual value guarantee is a variable interest because it protects the lessor entity's equity investors from negative variability in the fair value of the leased asset (i.e., the equity investors do not have the obligation to absorb all of the entity's economic risks). If the residual value guarantee covers only specified assets that comprise less than 50% of the fair value of the lessor entity's total assets, it would not be a variable interest in the lessor entity; rather it would be a variable interest in specified assets. Consideration should also be given to whether the residual value guarantee, in combination with other interests, create a "silo" within a VIE. See CG 3.7 through CG 3.8 for further discussion on variable interests in specified assets and silos.

□ *Lessee renewal options*

Renewal options in leases with rental payments at an amount other than fair value may be variable interests in the lessor entity. If a lease includes one or more renewal options, and those renewal options are not included in the lease term, as defined in ASC 842-10-20, the renewal option is a variable interest because it provides the lessee with the right to lease the assets for a period beyond the original lease term for rental payments that potentially differ from fair value. Thus, the renewal option captures a portion of the residual value of the asset.

If the lease renewal option is for specified assets that comprise less than 50% of the fair value of the lessor entity's total assets, the renewal option would not be a variable interest in the entity; rather, it would be a variable interest in specified assets.

□ *Lease prepayments to the lessor*

Lease prepayments to a lessor entity are in substance a loan that will be repaid over the term of the leased asset. Because a loan is generally a variable interest in the debtor, lease prepayments similarly should be considered a variable interest in the lessor entity.

See CG 5.1 for primary beneficiary analysis, particularly with respect to certain single asset owning special purpose entities (lessor entities).

3.5.2 ***Variable interests—entity is the lessee***

When the entity is the lessee, the lease should be treated like a debt instrument since these arrangements are, in essence, financing arrangements. That is, the reporting entity (lessor) would generally be viewed as having a variable interest in the entity to which it leases an asset.

3.6 ***“Implied” variable interests***

When applying the VIE model, in addition to assessing all explicit, direct interests in an entity, a reporting entity should evaluate whether any “implicit” variable interests exist in the entity. Implicit variable interests sometimes, but not exclusively, manifest themselves in situations where two related parties are involved with an entity, but only one has a direct variable interest in the entity. If deemed to exist, an implicit variable interest is treated no differently than an explicit variable interest when applying the VIE model.

An implicit variable interest is described as an interest that absorbs or receives the variability of an entity indirectly, rather than through direct interests in the entity.

ASC 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.

ASC 810-10-25-52 elaborates on the concept of an implied variable interest.

ASC 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 an 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.

In practice, the concept of an implied variable interest is generally used to describe two types of arrangements:

1. Variable interests “around” an entity
2. Noncontractual variable interests

Variable interests “around” an entity are often easier to identify as they arise from contractual relationships between parties involved with the entity being evaluated for consolidation. The following list of questions, which is not intended to be all-inclusive, may assist in identifying variable interests around an entity being evaluated for consolidation:

- Was the arrangement entered into in contemplation of the entity’s formation?
- Was the arrangement entered into contemporaneous with the entity’s issuance of a variable interest to another party?
- Why was the arrangement entered into with a variable interest holder instead of with the entity?
- Did the arrangement reference specified assets of the entity?

Noncontractual variable interests are more difficult to identify given the absence of explicit contractual relationships. Identifying implied variable interests stemming from noncontractual arrangements will depend on facts and circumstances and require the use of judgment. When performing this analysis, a reporting entity may find it useful to consider the impediments and incentives to why one entity would choose to protect another party involved with the entity being evaluated for consolidation from the entity’s expected variability.

The following table describes potential matters to consider when assessing one entity’s impediments and incentives to protect another party involved with an entity being evaluated for consolidation from its expected variability:

Impediments to protect	Incentives to protect
<ul style="list-style-type: none"> <input type="checkbox"/> Does the reporting entity have the capacity to provide protection to the other party involved with the entity? If so, in what form and to what extent? 	<ul style="list-style-type: none"> <input type="checkbox"/> Is the reporting entity a related party, have other fiduciary responsibilities to the other party, or under common control with the other party?
<ul style="list-style-type: none"> <input type="checkbox"/> Is the reporting entity subject to any debt covenants or similar contractual restrictions that would prevent it from protecting the other party involved with the entity? 	<ul style="list-style-type: none"> <input type="checkbox"/> How important is the arrangement to the reporting entity’s commercial success? Can the assets held by the entity being evaluated for consolidation be replicated, and/or can the reporting entity readily relocate the entity’s operations?

Impediments to protect

- Are there regulatory or statutory provisions that could constrain or prevent the reporting entity from providing protection to the other party involved with the entity, and/or could any such action raise other legal concerns, such as potential conflicts of interests?

Incentives to protect

- What are the consequences, if any, for the reporting entity in the event that the other party involved with the entity defaults on any of its obligations?

3.7 *Variable interests in specified assets*

ASC 810-10-25-55 through ASC 810-10-25-58 clarify under what circumstances a reporting entity should be considered to hold a variable interest in specified assets of an entity—rather than in the entity itself.

ASC 810-10-25-55

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

If a reporting entity has a variable interest in an asset, both of the following conditions must exist for a reporting entity to conclude that its variable interest is not in the entity as a whole:

- The variable interest relates to specified assets that comprise less than a majority of the total value of the entity's assets (on a fair-value basis)
- The reporting entity does not have another variable interest in the entity as a whole (except interests that are insignificant or have little or no variability)

We believe that this guidance applies only to variable interests in specified assets, and not specified liabilities. In contrast, a guarantee on the repayment of debt that is dependent on the general credit of the entity, regardless of how much debt the guarantee relates to, is a variable interest in the entity.

Example CG 3-11 illustrates the application of the variable interest in specified assets concept.

EXAMPLE CG 3-11

Assessing variable interests in specified assets

Assume that an entity owns two assets: a building worth \$5.2 million and equipment worth \$4.8 million. The building is leased to Reporting Entity A under a long-term lease, and Reporting Entity A

provides a residual value guarantee that the building will be worth at least \$4 million at the end of the lease's term. The equipment is leased to Reporting Entity B under a long-term lease, and Reporting Entity B provides a residual value guarantee that the equipment will be worth at least \$3 million at the end of the lease's term. Neither Reporting Entity A nor Reporting Entity B has other interests in the entity as a whole.

Does either Reporting Entity A or Reporting Entity B have a variable interest in the entity?

Analysis

Evaluation of residual value guarantee provided by reporting Entity A: The residual value guarantee provided by Reporting Entity A is a variable interest in the entity since the guarantee absorbs changes in the fair value of an asset that represents more than 50% of the total fair value of the entity's assets (the fair value of the building is 57% of the total fair value of assets).

Evaluation of residual value guarantee provided by reporting Entity B: The residual value guarantee provided by Reporting Entity B is not a variable interest in the entity since it protects the value of an asset that represents less than 50% of the total fair value of the entity's assets (the fair value of the asset is only 43% of the total assets). Since the residual value guarantee is not a variable interest, it is viewed as a creator rather than an absorber of variability. This is due to the fact that the residual value creates a floor for the fair value of the protected asset.

The determination of whether a variable interest is held in an entity or in a specified asset of the entity is based solely on the fair value of the asset relative to the fair value of the entity's total assets, and not the level of protection provided to the asset or rights to upside on the asset. The reporting entity's actual obligation related to the specified assets does not influence the evaluation. For example, a guarantee related to assets that represent 90% of the entity's assets (on a fair value basis) may be limited to 10% of the total loss in value of those assets. Although limited, that guarantee would constitute a variable interest in the entire entity.

3.7.1 How variable interests in specified assets affect expected losses

Whether a variable interest in specified assets is considered an interest in the entity that owns those assets or, instead, an interest in only those assets, can have repercussions on the consolidation analysis for the entity in question.

ASC 810-10-25-56

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

If a variable interest is determined to be a variable interest in specified assets and not a variable interest in the entity as a whole, the expected losses and expected residual returns related to those specified assets that are absorbed by such interests should be excluded from the calculation of the

entity's expected losses and expected residual returns. As a consequence, the entity's expected losses and expected residual returns are calculated net of the effects of any variable interests in specified assets that are not variable interests in the entity as a whole.

If an interest in specified assets of an entity is a variable interest in the entity as a whole, the losses related to those specified assets intended to be absorbed by the variable interest are included in the determination of the entity's expected losses for the purposes of determining whether the entity is a VIE (refer to CG 4.3 for information on assessing the sufficiency of an entity's equity investment). Said differently, the measurement of the entity's expected losses and expected residual returns are grossed up to the amounts that they would be absent the effects of the variable interest.

For example, if the guarantee in Example CG 3-11 only provided protection up to the first \$100,000 of losses on the equipment, expected losses of the entity would exclude the first \$100,000 of losses in the value of the equipment, but include the amount in excess of \$100,000 (i.e., losses not absorbed by the guarantee).

3.8 Silos: a VIE within a VIE

As noted in CG 3.1, the "unit of analysis" for purposes of applying the VIE model is a legal entity. Accordingly, a presumption exists that "virtual entities"—for example, a particular pool of assets owned by a legal entity that is pledged to secure an obligation of the entity—are not separate entities that warrant a discrete consolidation analysis. Unless the specific conditions discussed below are present, the legal entity serves as the unit of analysis under ASC 810.

The FASB was concerned that VIEs could be structured to separate the rights and obligations of different parties within a legal entity, thereby allowing those parties to avoid consolidation. As a result, the guidance includes the notion of a "silo" in the VIE model. A silo can be thought of as a VIE within a VIE, in which a party holds a variable interest in only selected assets of the larger legal entity.

ASC 810-10-25-57

A reporting entity with a variable interest in specified assets of a VIE shall treat a portion of the VIE as a separate VIE if the specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities or specified other interests. (The portions of a VIE referred to in this paragraph are sometimes called silos.) That requirement does not apply unless the legal entity has been determined to be a VIE. If one reporting entity is required to consolidate a discrete portion of a VIE, other variable interest holders shall not consider that portion to be part of the larger VIE.

ASC 810-10-25-58 emphasizes that, to be considered a silo, the underlying arrangements must meet stringent criteria indicative of a stand-alone, de facto entity.

ASC 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.

Given this restrictive guidance, we believe that silos will exist in very limited circumstances, and may be given recognition only if the following conditions are met:

- Specified assets, specified liabilities, and specified equity (if applicable) are clearly identifiable and separate from the overall entity
- Essentially (1) none of the returns from the separate assets are available to holders of interests in the larger VIE and (2) the specified liabilities are not paid using assets of the larger VIE
- The entity as a whole is a VIE

3.8.1 How silos affect the VIE analysis

A silo can exist only within a legal entity deemed to be a VIE. If the silo is deconsolidated from the larger VIE, expected losses and expected residual returns attributable to the silo should be excluded from the calculation of expected losses and expected residual returns of the larger legal entity. The analysis involves the following steps:

- Identify potential silos
- Determine whether a primary beneficiary exists for the potential silo
- If so, exclude the expected losses and expected residual returns of the potential silo from the overall entity

Performing these steps complicates the expected-loss assessment of the larger legal entity. However, because silos exist in relatively few instances, we expect that most reporting entities will find it unnecessary to undertake this more exhaustive analysis.

***Chapter 4:
Determining whether an
entity is a VIE—updated
December 2022***

4.1 *Determining whether an entity is a VIE*

One of most critical steps in applying the VIE model is assessing whether an entity is a VIE. The overall objective is to identify those entities for which voting interests are not effective in determining which party has a controlling financial interest in the entity. The VIE model assumes that the holders of voting equity do not have traditional characteristics of control (and therefore that the entity is a VIE) if any of the following conditions exist:

- The entity is thinly capitalized (i.e., the equity is not sufficient to fund the entity’s activities without additional subordinated financial support)
- The equity holders as a group have one of the following four characteristics:
 - Lack the power to direct activities that most significantly impact the entity’s economic performance
 - Possess nonsubstantive voting rights
 - Lack the obligation to absorb the entity’s expected losses
 - Lack the right to receive the entity’s expected residual returns

The VIE model requires the reporting entity to determine whether an entity is a VIE at the time of its creation (or on the reporting entity’s first date of involvement with that entity), and to re-evaluate whether or not that entity is a VIE if certain events occur.

4.2 *Identify the equity investment at risk*

The reference to “equity” in the characteristics of a VIE refers to equity that is considered at risk. “Equity at risk” is a defined term and identifying it is an important first step in applying the VIE model.

Excerpt from ASC 810-10-15-14(a)

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.

Equity investments that are recorded in the equity section of the entity's GAAP financial statements are the starting point for this evaluation. However, just because an investment is presented as equity does not necessarily mean that it qualifies as equity at risk. A careful analysis is necessary to ensure that an equity investment meets the conditions necessary to qualify as equity at risk.

Excerpt from ASC 810-10-15-14(a)

Equity investments in a legal entity are interests that are required to be reported as equity in that entity's financial statements.

Figure CG 4-1 provides an overview of how the amount of an entity's total equity investment at risk is calculated:

Figure CG 4-1
Calculating an entity's total equity investment

GAAP equity investment	
Less:	Equity investments that do not participate significantly in the entity's profits and losses (see ASC 810-10-15-14(a)(1))
Less:	Equity investments in an entity that are the source of subordinated financial support for another VIE (see ASC 810-10-15-14(a)(2))
Less:	Equity investments provided to the equity investor by the entity or other parties involved with the entity (see ASC 810-10-15-14(a)(3))
Less:	Equity investments financed for the equity investor by the entity or other parties involved with the entity (see ASC 810-10-15-14(a)(4))

An analysis should be performed to understand the nature of interests issued by a potential VIE, and to ensure that those interests would be reported as GAAP equity in the potential VIE's financial statements. For example, if the potential VIE issued date-certain redeemable preferred stock that was required to be accounted for as a liability pursuant to ASC 480, those interests (the preferred stock) would not be recorded as GAAP equity and therefore would be excluded from equity at risk. However, if those preferred equity interests were presented as temporary equity pursuant to ASC 480-10-S99, *Classification and Measurement of Redeemable Securities*, they would be included in the calculation of equity at risk provided they meet all the requirements described later in this section.

Slight changes in the form of the equity, particularly certain preferred stock investments, may result in different conclusions as to whether such instruments qualify as equity at risk. Many entities are established with investments that economically are very similar to equity (e.g., subordinated debt), but are not reported as equity for GAAP financial reporting purposes. These investments cannot be considered part of the equity investment at risk.

In addition, commitments to fund the potential VIE's future operations or promises to provide cash in the future in exchange for an equity interest (i.e., a stock subscription) are generally not considered GAAP equity as they would not be reported as equity in the potential VIE's financial statements. An equity subscription receivable is generally accounted for by recording an equal and offsetting debit in the equity section of the entity's financial statements, therefore, these equity investments do not qualify as equity investment at risk.

After the components of GAAP equity are identified, the next step is to assess whether the equity is considered at risk. A reporting entity must consider the four conditions set forth in ASC 810-10-15-14(a) to conclude that GAAP equity is at risk for purposes of applying the VIE model. If a potential VIE has more than one investor, a reporting entity must evaluate each investment separately against the four conditions.

4.2.1 ***Equity must participate significantly in profits/losses***

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

We believe the term "profits and losses" refers to GAAP profits and losses (as opposed to expected losses and expected residual returns). This means that the equity investment must share (or participate) in the net income or loss of the entity. Some equity investments may share only in the profits of the entity and are not exposed to the losses of the entity. In such circumstances, the equity investment would not be considered equity at risk.

Example CG 4-1 illustrates the determination of whether an equity investment with a guaranteed minimum return qualifies as equity at risk.

EXAMPLE CG 4-1

Determining whether an equity investment with a guaranteed minimum return qualifies as equity at risk

Company A contributed \$1,000 of cash into Entity B at formation in exchange for 20% of Entity B's common stock. Company A's common equity investment participates pro rata in Entity B's profits and losses; however, the terms of Company A's interest stipulate that it must receive, at a minimum, an annual 8% rate of return on its investment.

Does Company A's equity investment participate significantly in Entity B's profits and losses?

Analysis

Generally, no. Although Company A's equity investment may participate significantly in Entity B's profits, the minimum guaranteed return demonstrates that Company A may not necessarily participate significantly in Entity B's losses. As a result, assuming Company A's guaranteed minimum return is substantive (i.e., Entity B has adequate equity that is (1) subordinated to Company A's equity investment, and (2) capable of funding Company A's guaranteed minimum return in periods where Company B incurs operating losses), Company A's equity investment may not qualify as equity at risk.

***Chapter 4:
Determining whether an
entity is a VIE—updated
December 2022***

4.1 *Determining whether an entity is a VIE*

One of most critical steps in applying the VIE model is assessing whether an entity is a VIE. The overall objective is to identify those entities for which voting interests are not effective in determining which party has a controlling financial interest in the entity. The VIE model assumes that the holders of voting equity do not have traditional characteristics of control (and therefore that the entity is a VIE) if any of the following conditions exist:

- The entity is thinly capitalized (i.e., the equity is not sufficient to fund the entity’s activities without additional subordinated financial support)
- The equity holders as a group have one of the following four characteristics:
 - Lack the power to direct activities that most significantly impact the entity’s economic performance
 - Possess nonsubstantive voting rights
 - Lack the obligation to absorb the entity’s expected losses
 - Lack the right to receive the entity’s expected residual returns

The VIE model requires the reporting entity to determine whether an entity is a VIE at the time of its creation (or on the reporting entity’s first date of involvement with that entity), and to re-evaluate whether or not that entity is a VIE if certain events occur.

4.2 *Identify the equity investment at risk*

The reference to “equity” in the characteristics of a VIE refers to equity that is considered at risk. “Equity at risk” is a defined term and identifying it is an important first step in applying the VIE model.

Excerpt from ASC 810-10-15-14(a)

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.

Equity investments that are recorded in the equity section of the entity's GAAP financial statements are the starting point for this evaluation. However, just because an investment is presented as equity does not necessarily mean that it qualifies as equity at risk. A careful analysis is necessary to ensure that an equity investment meets the conditions necessary to qualify as equity at risk.

Excerpt from ASC 810-10-15-14(a)

Equity investments in a legal entity are interests that are required to be reported as equity in that entity's financial statements.

Figure CG 4-1 provides an overview of how the amount of an entity's total equity investment at risk is calculated:

Figure CG 4-1
Calculating an entity's total equity investment

GAAP equity investment	
Less:	Equity investments that do not participate significantly in the entity's profits and losses (see ASC 810-10-15-14(a)(1))
Less:	Equity investments in an entity that are the source of subordinated financial support for another VIE (see ASC 810-10-15-14(a)(2))
Less:	Equity investments provided to the equity investor by the entity or other parties involved with the entity (see ASC 810-10-15-14(a)(3))
Less:	Equity investments financed for the equity investor by the entity or other parties involved with the entity (see ASC 810-10-15-14(a)(4))

An analysis should be performed to understand the nature of interests issued by a potential VIE, and to ensure that those interests would be reported as GAAP equity in the potential VIE's financial statements. For example, if the potential VIE issued date-certain redeemable preferred stock that was required to be accounted for as a liability pursuant to ASC 480, those interests (the preferred stock) would not be recorded as GAAP equity and therefore would be excluded from equity at risk. However, if those preferred equity interests were presented as temporary equity pursuant to ASC 480-10-S99, *Classification and Measurement of Redeemable Securities*, they would be included in the calculation of equity at risk provided they meet all the requirements described later in this section.

Slight changes in the form of the equity, particularly certain preferred stock investments, may result in different conclusions as to whether such instruments qualify as equity at risk. Many entities are established with investments that economically are very similar to equity (e.g., subordinated debt), but are not reported as equity for GAAP financial reporting purposes. These investments cannot be considered part of the equity investment at risk.

In addition, commitments to fund the potential VIE's future operations or promises to provide cash in the future in exchange for an equity interest (i.e., a stock subscription) are generally not considered GAAP equity as they would not be reported as equity in the potential VIE's financial statements. An equity subscription receivable is generally accounted for by recording an equal and offsetting debit in the equity section of the entity's financial statements, therefore, these equity investments do not qualify as equity investment at risk.

After the components of GAAP equity are identified, the next step is to assess whether the equity is considered at risk. A reporting entity must consider the four conditions set forth in ASC 810-10-15-14(a) to conclude that GAAP equity is at risk for purposes of applying the VIE model. If a potential VIE has more than one investor, a reporting entity must evaluate each investment separately against the four conditions.

4.2.1 ***Equity must participate significantly in profits/losses***

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

We believe the term “profits and losses” refers to GAAP profits and losses (as opposed to expected losses and expected residual returns). This means that the equity investment must share (or participate) in the net income or loss of the entity. Some equity investments may share only in the profits of the entity and are not exposed to the losses of the entity. In such circumstances, the equity investment would not be considered equity at risk.

Example CG 4-1 illustrates the determination of whether an equity investment with a guaranteed minimum return qualifies as equity at risk.

EXAMPLE CG 4-1

Determining whether an equity investment with a guaranteed minimum return qualifies as equity at risk

Company A contributed \$1,000 of cash into Entity B at formation in exchange for 20% of Entity B's common stock. Company A's common equity investment participates pro rata in Entity B's profits and losses; however, the terms of Company A's interest stipulate that it must receive, at a minimum, an annual 8% rate of return on its investment.

Does Company A's equity investment participate significantly in Entity B's profits and losses?

Analysis

Generally, no. Although Company A's equity investment may participate significantly in Entity B's profits, the minimum guaranteed return demonstrates that Company A may not necessarily participate significantly in Entity B's losses. As a result, assuming Company A's guaranteed minimum return is substantive (i.e., Entity B has adequate equity that is (1) subordinated to Company A's equity investment, and (2) capable of funding Company A's guaranteed minimum return in periods where Company B incurs operating losses), Company A's equity investment may not qualify as equity at risk.

Even when an equity investment participates in the profits and losses of a potential VIE, the investment's level of participation must be "significant" for that equity investment to qualify as equity at risk. The determination of whether an equity investment participates significantly in profits and losses is based solely on the specific facts and circumstances. The following factors should be considered when making this assessment.

Fixed rates of return or low levels of returns or loss

Investments with a fixed rate of return generally do not participate significantly in the profits and losses of an entity. However, the substance of an arrangement should prevail over its form. If an equity investor is entitled to a fixed rate of return and that return is substantial relative to the entity's overall equity return, the equity investment may participate significantly in the entity's profits. To qualify as equity at risk, an equity investment must also participate significantly in the entity's losses.

Determining whether an equity investment is substantive

An equity investment that participates in an entity's profits and losses at a level that is consistent with its relative equity ownership (e.g., a 1% general partnership interest that participates in 1% of the entity's profits and losses) would participate significantly in profits and losses as long as that equity investment is substantive.

Sometimes equity interests are issued for de minimis amounts and, as a result, that investor may not participate significantly in losses.

Example CG 4-2 illustrates the determination of whether a general partner interest participates significantly in a limited partnership's profits and losses.

EXAMPLE CG 4-2

Determining whether a general partner interest participates significantly in a limited partnership's profits and losses

A general partner purchases a 1% general partner interest for \$1,000, while 99 limited partners each receive a 1% interest for their contributions of \$1,000,000 (\$99 million in total).

Does the general partner's interest participate significantly in the limited partnership profits and losses?

Analysis

No. Under this scenario, the general partner's interest would not participate significantly in the profits and losses based on what the general partner paid for its 1% interest relative to the price paid by the LPs for their 1% interests (i.e., it is not substantive). In making this assessment, we believe the dollar amount and percentage of the investment relative to the total equity investments should be considered.

The general partner's interest would be substantive and therefore qualify as equity at risk if (1) the general partner contributed \$1 million for its 1% pro rata equity investment (like all other investors) and (2) the general partner's investment participated pro rata in the limited partnership's profits and

losses. However, if the general partner's percentage interest is trivial (i.e., 0.1%) then its investment would not be at risk irrespective of the price paid.

Guaranteed returns

Generally, when an equity investor's returns are guaranteed by another party involved with the entity, the investor's equity investment does not participate significantly in the losses of the entity.

Equity instruments that are redeemable or callable

Oftentimes, investors can put (redeem) their equity interests (purchased put options) or are required to sell their equity interests to a third party at the third party's option (written call options). These put and call options are often exercisable at fixed prices or prices determined based on a formula. In determining whether these features would prevent an equity investment from participating significantly in the profits and losses of the entity, we believe a reporting entity should first determine whether those characteristics are embedded in the terms of the equity investment. Embedded terms are part of the equity investment's features so they must be considered in the analysis. Freestanding puts and calls on equity may have to be included in the equity at risk analysis, as discussed further below.

Puttable or callable characteristics arising from a freestanding contract

When the puttable or callable characteristics result from a freestanding contract with a third party (i.e., a party that is not involved with the potential VIE) that was not executed as part of the entity's purpose and design (e.g., as part of the equity investor's normal trading activities), we do not believe the puttable or callable characteristics would preclude that equity interest from qualifying as equity at risk.

If, however, the equity investor executed the freestanding contract with the potential VIE or a party involved with the potential VIE as part of the purpose and design of the entity, we believe these characteristics would need to be considered in the analysis and may preclude the equity interest from qualifying as equity at risk if they substantively protect the investor from losses, or prohibit the investor from participating significantly in the entity's profits.

If the puttable or callable characteristics are embedded in the terms of the contract, or arise from a freestanding contract executed as part of the design of the potential VIE, the following factors should be considered to determine whether the equity investment qualifies as equity at risk:

- The length of the period of time during which the put or call option may be exercised
- Terms associated with the put or call option, including the option's strike price (e.g., fixed, variable, or fair market value)

If an equity investment is puttable or callable at the instrument's then current fair value, or at a fixed price that is significantly out-of-the-money, that investment would likely participate significantly in the profits and losses of the potential VIE. In contrast, if the equity investment is puttable or callable at a fixed price that is in-the-money or at an amount that is not significantly out-of-the-money, we

believe the investor may not participate significantly in the potential VIE's profits and losses. This would preclude the underlying equity interest from qualifying as equity at risk.

Judgment may be required when an equity instrument is puttable or callable at an amount that is determined by a formula. Specifically, a reporting entity should consider whether the formula amount substantively limits the equity investor's exposure to the entity's profits or losses.

Question CG 4-1

Does a hybrid equity instrument that contains an embedded derivative requiring separation under the provisions of ASC 815-15-25 qualify as an equity investment at risk?

PwC response

It depends. An embedded derivative that must be separated from its host contract pursuant to 815-15-25 must be classified as an asset or liability, and therefore would be excluded from the total equity investment at risk. However, the residual value ascribed to a host contract that is accounted for as GAAP equity might qualify as equity investment at risk, assuming the host contract meets the other necessary requirements. A reporting entity should determine whether the GAAP equity-classified host contract participates significantly in the potential VIE's profits and losses to determine whether that equity investment qualifies as equity at risk. The equity classified host contract would not qualify as equity at risk if, for example, the separated derivative was a put option that is not significantly out-of-the-money. In that circumstance, the put option would protect the equity investor(s) from the entity's expected losses, thereby disqualifying the equity classified host instrument from the potential VIE's total equity investment at risk.

4.2.2 *Equity issued for subordinated financial support in another VIE*

ASC 810-10-15-14(a)(2)

Does not include equity interests that the legal entity issued in exchange for subordinated interests in other VIEs.

The objective of this provision is to ensure that a particular equity investment is not used to capitalize two entities (i.e., the equity investment should count only once).

Example CG 4-3 illustrates the determination of whether an equity investment acquired in exchange for a subordinated interest in another VIE qualifies as equity at risk.

EXAMPLE CG 4-3

Determining whether an equity investment acquired in exchange for a subordinated interest in another VIE qualifies as equity at risk

Reporting Entity X contributed \$1,000 of cash to Entity A, a VIE, at formation in exchange for a 30% equity interest in Entity A. Reporting Entity X then contributed its 30% equity interest in Entity A to Entity B in exchange for 40% of Entity B's common equity.

Does Reporting Entity X's common equity investment in Entity B qualify as equity at risk?

Analysis

No. Reporting Entity X's equity investment in Entity B is not considered equity at risk since the equity investment was acquired in exchange for a subordinated interest issued by another VIE, Entity A.

If, however, Entity A was not a VIE, then Reporting Entity X's equity interest in Entity B would be considered equity at risk assuming all other criteria in ASC 810-10-15-14(a) were met.

4.2.3 Equity provided by parties involved with the entity**ASC 810-10-15-14(a)(3)**

Does not include amounts provided to the equity investor directly or indirectly by the legal entity or by other parties involved with the 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.

An equity investment is not at risk if the cash (or other assets) used to make the investment was obtained through fees, a charitable contribution, or other forms of payment made to the investor from another party involved with the entity. Stated differently, only an equity investment made by an equity investor that has "skin in the game" is considered equity at risk.

A literal reading of the guidance suggests that all fees paid to an equity investor by the potential VIE, or by others involved with the potential VIE, would reduce the entity's equity investment at risk. We believe that the facts and circumstances should be considered when determining whether such fees are, in substance, a return of capital and therefore reduce the amount of equity at risk.

ASC 810 provides examples of payments to an equity investor that can result in a reduction in an investor's at-risk equity, including upfront fees, third-party reimbursements, and fees paid over time.

Upfront fees

Generally, fees paid concurrent with the formation of an entity (or shortly thereafter) would be considered a return of the amounts invested by the equity investor. Examples of such fees include structuring, syndication, management, or development fees.

Payments and fees paid by any party that was involved with the entity should be evaluated to determine whether they disqualify the investor's equity investment, in whole or in part, from being at risk.

Example CG 4-4 illustrates the impact of upfront fees paid to an equity investor on the calculation of total equity investment at risk.

EXAMPLE CG 4-4**Impact of upfront fees paid to an equity investor on the calculation of total equity investment at risk**

Company A contributed \$15 of cash to Entity B at formation in exchange for 100% of Entity B's common equity. Entity B subsequently obtained \$85 of nonrecourse debt and paid Company A \$10, which represents a fee for development services Company A will perform in the future. The fee paid to Company A is fair value for the future services to be provided.

Does the fee paid by Entity B to Company A prevent Company A's equity investment, in whole or in part, from being considered equity at risk?

Analysis

Yes. Company A's equity investment at risk must be reduced by the amount of upfront fees received from Entity B for future development services. As such, the equity investment at risk would be \$5, calculated as Company A's \$15 capital contribution less the \$10 upfront development fee received from Entity B for future development services.

Example CG 4-5 illustrates the determination of whether a general partner's equity investment qualifies as equity at risk when purchased using fees received from the entity.

EXAMPLE CG 4-5**Determining whether a general partner's equity investment qualifies as equity at risk when purchased using fees received from the entity**

A general partner forms a limited partnership and receives a \$100 syndication fee. The general partner then contributes \$10 for a 1% general partner interest.

Does the general partner's 1% equity interest qualify as equity at risk?

Analysis

No. The general partner's investment would not qualify as equity at risk since an upfront fee received from the limited partnership for services provided was used to fund the purchase of its interest.

Third-party reimbursements

Generally, payments that an equity investor receives from the entity that are used to pay an unrelated third party for a service performed for the entity would not affect the amount of the investor's equity investment that would be considered at risk. The investor would not benefit from the monies received, so the amount invested in the entity would still be considered equity at risk.

Fees paid over time

If an equity investor is entitled to future fees that are at market and commensurate (refer to CG 3.4.1 for further discussion), its equity at risk would not be reduced by any portion of the future fees. In contrast, if the investor is entitled to future fees that are above market, and the investor is unconditionally entitled to such fees, then the present value of the total expected fee that exceeds the

market rate should be treated as a reduction of the potential VIE's total equity at risk. We believe such amounts represent, in substance, a guaranteed return on the investor's equity interest.

Under certain arrangements, an entity may grant "sweat equity" to certain parties at the date on which an entity is established. Rather than granting this equity in exchange for cash, the equity may be granted for recognition of the party's past or potential future efforts in the arrangement. For example, entities established for the acquisition, development, or construction of real estate or technology start-ups often grant "sweat equity" to developers/builders/founders for their efforts after the inception of the arrangement.

Question CG 4-2

Would "sweat equity" meet the criteria for being included in the equity investment at risk?

PwC response

No. Sweat equity is not considered equity at risk. In effect, sweat equity is financed for the equity investor (service provider) by the potential VIE.

4.2.4 *Equity financed by the entity or other parties involved with the entity*

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

The purpose of this condition is to exclude from the equity at risk amounts funded from sources other than the equity investor. The burden of the investors to absorb potential losses decreases when the entity, or other parties that are involved with the entity, provide loans or guarantees of loans to the equity investors.

In these circumstances, the funding that supports the entity is provided by parties providing the loan to the equity investor or guaranteeing debt financing used by the equity investor to fund its interest, as opposed to the equity investors. ASC 810 specifically prohibits equity investments from qualifying as equity at risk when the source of funds used by the equity investor to acquire its equity interest are provided by (1) the potential VIE or (2) other parties involved with the potential VIE, unless those other parties are included in the same set of consolidated financial statements as the equity investor.

If the borrowed funds were received from an individual or entity that is not involved with the potential VIE, then the equity investment acquired using the borrowed funds would be considered equity at risk, assuming it meets all other necessary conditions.

A reporting entity that makes a contribution or loan to another party that is used to acquire an equity interest in a potential VIE may also create a de facto agency relationship as discussed in CG 5.4. This may have significant ramifications when determining whether a decision-making fee is a variable

interest (refer to CG 3.4), and whether a variable interest holder is the primary beneficiary of a VIE (refer to CG 5).

Example CG 4-6 illustrates the determination of whether an equity investor's interest is at risk when purchased using borrowed funds from a party involved with the VIE.

EXAMPLE CG 4-6

Determining whether an equity investor's interest is at risk when purchased using borrowed funds from a party involved with the VIE

Investor A loans Investor B \$500, and Investor B uses the \$500 to acquire a 50% interest in Partnership X. Investor A contributes \$500 in cash and also receives a 50% interest in Partnership X. Investor A and Investor B are each required to consent to all decisions related to Partnership X's activities that most significantly impact its economic performance (i.e., power is shared).

Analysis

Investor B's equity investment is excluded from total equity investment at risk because Investor A provided the financing for that investment. In addition, Investor A and Investor B would be considered VIE related parties (de facto agents), which could have ramifications if Partnership X is a VIE and neither Investor A nor Investor B meet both conditions necessary to be the primary beneficiary of Partnership X on a stand-alone basis.

4.2.5 Equity at risk – activities around the entity

Conceptually, reporting entities are required to consider activities “around the entity” to capture circumstances where entities are structured to avoid consolidation. Examples of relationships or transactions “around the entity” that should be considered when assessing whether an investor's equity interest qualifies as equity at risk include the following:

- Loans between an entity's equity investors
- Purchased and sold put and call options
- Service arrangements with investors and non-investors
- Derivatives financial instruments (e.g., total-return swaps)

If relationships and transactions “around the entity” prevent the holders of equity at risk from participating significantly in the entity's profits and losses, then those equity investments should be excluded from the calculation of equity at risk. If those transactions or relationships cause some or all of the entity's equity investments to be excluded from equity investment at risk, this could lead to the conclusion that the entity is VIE due to insufficient capitalization. Refer to CG 3.6 for further discussion.

Once the holders of equity investment at risk have been identified, the reporting entity should determine whether any of the five characteristics of a VIE as described in ASC 810-10-15-14 are present. If a single VIE characteristic is present, then the entity is a VIE and the reporting entity must determine whether it is the VIE's primary beneficiary (as discussed further in CG 5).

4.3 **VIE Characteristic 1: insufficient equity investment at risk – updated September 2023**

The first characteristic of a VIE focuses on the sufficiency of the potential VIE's total equity investment at risk. An entity is sufficiently capitalized when its total equity investment at risk is sufficient to finance its expected activities without additional subordinated financial support. If the potential VIE requires additional subordinated financial support to finance its expected activities, then Characteristic 1 would be present and the party providing the additional financing may restrict or even prohibit the equity investors from making decisions that are counter to the interests of the parties providing additional financing. Consequently, placing primary reliance on voting rights (as prescribed by the voting interest model) may not result in an accurate conclusion regarding which party holds a controlling financial interest.

To determine whether Characteristic 1 is present, a reporting entity should evaluate whether the potential VIE's total equity investment at risk exceeds the potential VIE's total *expected* losses (i.e., the potential negative variability in the returns of the entity). To be sufficient, the potential VIE's equity at risk must be large enough to absorb the potential downside variability of the entity's activities (its expected losses). If the total equity investment at risk is less than the potential VIE's total expected losses, the entity would not be sufficiently capitalized and therefore would be a VIE.

When calculating total equity investment at risk, we believe the securities comprising equity should be evaluated based on their fair value as of the date the analysis is performed. That date may differ from the entity's formation date if the reporting entity became involved with the potential VIE post-inception.

In some instances, the book value of the entity's equity may equal its fair value, or be a reasonable proxy for its fair value. Other times, an entity's book value of equity may not be a reasonable proxy for its fair value. There are cases when, even at formation, the fair value of an entity's equity differs from its book value. This would be the case, for example, in the formation of a joint venture prior to the adoption of ASU 2023-05, when the joint venture may be required to record the assets contributed at carry-over historical cost. After the adoption of ASU 2023-05, a joint venture is required to record all assets contributed upon formation using a new basis of accounting, consistent with ASC 805 (refer to EM 6.4 for further discussion of ASU 2023-05). Because the concepts of variable interests and expected losses are based on fair value assumptions, using the fair value of an entity's equity will provide for consistent comparisons when evaluating whether an entity is a VIE.

The VIE model establishes a rebuttable presumption that all entities with equity investment at risk of less than 10% of the fair value of the entity's total assets are VIEs. However, that presumption may be overcome using qualitative or quantitative evidence demonstrating that the equity investment at risk of less than 10% may be sufficient.

ASC 810-10-25-45

An equity investment at risk of less than 10 percent of the legal entity's total assets shall not be considered sufficient to permit the 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.

This does not necessarily mean that equity investment at risk of more than 10% is automatically deemed sufficient.

ASC 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 entity's assets or liabilities. The presumption in the preceding paragraph does not relieve a reporting entity of its responsibility to determine whether a particular entity with which the reporting entity is involved needs an equity investment at risk greater than 10 percent of its assets in order to finance its activities without subordinated financial support in addition to the equity investment.

The VIE model does not provide "rules" for determining what amount of equity is required to be sufficient. The 10% presumption does not provide a safe harbor for all equity investments that are equal to, or greater than, 10% of the fair value of an entity's total assets. Reporting entities involved with potential VIEs must demonstrate that the equity investment at risk is sufficient if the equity exceeds 10% of the fair value of the potential VIE's assets.

4.3.1 Qualitative assessment: sufficiency of equity investment at risk

ASC 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.

ASC 810-10-25-45(a) through (b) provides two indicators that a reporting entity can consider to demonstrate that an entity is sufficiently capitalized. If either of these qualitative conditions provide evidence that the entity is sufficiently capitalized, the presumption that the entity is thinly capitalized can be overcome and the entity would not be a VIE under Characteristic 1.

- **Ability to finance activities without additional subordinated financial support:** Entities that have issued investment-grade senior debt may be able to qualitatively demonstrate that the entity can finance its operations without additional subordinated financial support. Entities that have issued low-risk debt demonstrate that they are able to obtain financing that is low-risk with an interest rate that is commensurate with those low-risk activities. Even if the entity has issued subordinated debt, there may be circumstances when the entity can demonstrate that it has sufficient equity at risk, for example, if the subordinated debt carries an investment grade credit rating. The grade and related interest rate of the subordinated debt must be evaluated to determine whether it is comparable with the grade and interest rate of other low-risk (i.e., “debt-like”) investments.

Depending on the nature and grade of the entity’s debt and other financing, the entity may be unable to qualitatively demonstrate that its equity at risk is sufficient, even if it has diversified assets and risks. If the potential VIE issued debt that is more “equity-like” in nature, we believe the reporting entity will be unable to qualitatively conclude that the entity is sufficiently capitalized.

- **The entity’s total equity investment at risk is greater than, or equal to, other entities that hold only similar assets of similar quality and amounts and operate with no additional subordinated financial support:** It may be difficult to find another entity (1) with assets that are similar in quality and amounts, and (2) without additional subordinated financings in its capital structure. For this reason, it is often difficult to demonstrate this condition exists when qualitatively assessing the sufficiency of total equity investment at risk.

Other non-equity sources of financing may demonstrate that an entity is sufficiently capitalized. Qualitative factors that may be useful in assessing the sufficiency of an entity’s equity investment at risk may include the following:

- The purpose and design of the entity
- The intentions of the parties that established the entity
- The credit rating of the entity
- The rate of interest the entity is required to pay to its lenders
- The terms of the company’s financing arrangements

Since debt may function as a surrogate for additional equity investments, the quality of the debt and associated interest rate are important factors to consider in this analysis. We believe that an entity’s ability to obtain investment-grade debt (at least a rating of BBB by Standard and Poor’s or

Baa by Moody's) may be evidence that the equity investment at risk is sufficient and that the lender's risk of loss is remote.

On the other hand, higher-risk financing may indicate that the lender (or other parties) shares in the risks of a potential VIE's activities by absorbing a significant amount of the potential VIE's expected losses. This assessment becomes more difficult when debt is not the only type of variable interest that may provide additional subordinated financial support. The existence of guarantees on the value of a potential VIE's assets, put options allowing the equity investors to sell their interests at prices other than fair value, and similar arrangements are also variable interests that may also be a source of additional subordinated financial support. Such interests may also impact the quality of the debt that the potential VIE can procure.

Non-investment grade debt

The mere existence of subordinated debt (i.e., "high yield," "mezzanine," or "junk" debt) is not conclusive that an entity is thinly capitalized. If after considering the relevant facts and circumstances, a reporting entity is unable to conclude qualitatively that a potential VIE is sufficiently capitalized, a quantitative analysis would be required to determine whether Characteristic 1 is present. This quantitative analysis would compare the entity's total equity investment at risk to the entity's expected losses. If the results of this quantitative analysis demonstrate that the entity's expected losses exceed the entity's equity investment at risk, then the entity's equity investment at risk is not sufficient and the entity would be a VIE.

Depending on the facts and circumstances of the arrangement, the existence of guarantees of an entity's debt may indicate that the equity investment at risk is insufficient. For example, if a personal guarantee was necessary for the entity to receive financing from a third-party bank, the equity investment at risk may not be sufficient.

SPEs

Typically in SPEs, other arrangements with the entity or other parties associated with the entity, as opposed to the holders of investments in equity at risk, bear most of the risk of loss related to the entity's activities and often receive most of the residual benefit of the SPE's activities. These other arrangements function in a manner that is often associated with an equity investment.

SPEs that are structured in such a manner will often be VIEs because the equity investment at risk will be insufficient. Such entities will likely be insufficiently capitalized because their total equity investment at risk does not exceed the entity's expected losses.

Equity investors and commitments to fund equity, loans, and guarantees

An equity investment that is issued in return for an obligation to provide additional capital in the future is generally not considered equity at risk. The receivable recorded by the potential VIE is typically recorded as an offset (i.e., reduction) to GAAP equity, thereby reducing the total equity investment at risk. In addition, an entity may be thinly capitalized (and therefore a VIE) if an investor is obligated to fund the potential VIE's activities on an ongoing basis (i.e., "step" funding arrangements).

Commitments to finance future acquisitions

In some cases, a potential VIE's equity investors may agree to finance future acquisitions as part of the potential VIE's strategy or business plan. This agreement to finance future acquisitions does not necessarily mean that an entity is insufficiently capitalized. Rather, if an entity is currently able to operate its business with equity that is currently deemed to be sufficient, the fact that the entity has an agreement with its equity investors to finance future acquisitions does not cause the entity to be insufficiently capitalized. However, care and judgment should be exercised to ensure that the future acquisitions are not currently needed to operate the business in its current state. In addition, an entity's current ability to independently finance its operations without additional subordinated financial support from its equity investors should be considered. For example, if an entity is currently able to finance its operations with investment grade debt, it would not be considered insufficiently capitalized even if it has an agreement with its equity investors to finance future acquisitions.

Example CG 4-7 illustrates the determination of whether commitments to fund future acquisitions demonstrate that an entity is thinly capitalized.

EXAMPLE CG 4-7**Determining whether commitments to fund future acquisitions demonstrate that an entity is thinly capitalized**

Company A forms Company X and contributes an existing business that provides services to retail and business consumers with a fair value of \$1 million. The contributed business is in the mature phase of the business life cycle and finances its activities through cash flows generated from its operations. Company X's capital structure is comprised entirely of common equity.

Company B, a financial investor, contributes \$500 thousand to Company X in exchange for a 50% equity interest. Company B's cash contribution is immediately distributed to Company A, resulting in an equalization of each party's contribution to Company X.

The business plan of Company X contemplates the acquisition of other similar service businesses, with the intention of growing Company X through acquisition and exiting through a sale or initial public offering. Company A and Company B jointly agreed to fund the acquisition of each target company identified when and if the acquisition closes. Company A and Company B will each fund their respective share of the purchase price in proportion to their relative ownership interest in Company X (i.e., 50/50).

Should Company A and Company B's contingent commitment to fund future acquisitions result in the conclusion that Company X is insufficiently capitalized as of the formation date?

Analysis

No. Company A's evaluation of the sufficiency of Company X's equity at risk should be based on whether Company X requires additional subordinated financial support to finance its current activities as of the date the analysis is performed. We do not believe contingent commitments to finance future acquisitions should lead to the conclusion that Company X is insufficiently capitalized in isolation. This view is premised on the notion that an investor's commitment to finance future acquisitions is different from a commitment to finance an entity's current activities. The decision to acquire a group of assets or a business represents an action that is ordinarily outside the normal course of business for

an operating entity. We believe this differs from situations where an investor commits to provide additional capital to finance an entity's current activities or to fund normal course capital expenditures.

Determining whether such commitments cause an entity to be a VIE under Characteristic 1 requires judgment. This analysis should be based on the entity's particular facts and circumstances and consider the entity's purpose and design.

4.3.2 Quantitative assessment: sufficiency of equity investment at risk

If the reporting entity is unable to qualitatively overcome the presumption that the potential VIE is insufficiently capitalized, the quantitative analysis described in ASC 810-10-25-45(c) would be required to conclude that the entity is sufficiently capitalized. This quantitative approach, which can be costly and time consuming, particularly for operating entities, requires a reporting entity to project the potential VIE's operating results and expected cash flows well into the future. The entity's expected losses should then be compared to the total equity investment at risk to assess the sufficiency of the total equity investment at risk. If the entity's total equity investment at risk is less than the entity's expected losses, the entity would be considered insufficiently capitalized and therefore a VIE under Characteristic 1.

4.4 VIE Characteristic 2: equity lacks decision making rights

The second characteristic of a VIE focuses on whether the "at risk" equity investors have the ability to make decisions that significantly impact the economic performance of the potential VIE. The underlying principle of Characteristic 2 is that if the equity investors lack the power to direct the activities that have the most significant impact on the economic performance of the entity, it can be inferred that a party other than the equity investor(s) most likely controls the entity. In those circumstances, a consolidation model that focuses on relative voting rights may not be useful in identifying which party, if any, holds a controlling financial interest in the entity.

Excerpt from ASC 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.

4.4.1 Applying Characteristic 2 to corporations and similar entities

Excerpt from ASC 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.

The application of Characteristic 2 to entities other than limited partnerships (e.g., entities governed by a board of directors, such as corporations) centers on whether the holders of equity at risk, as a group, have rights (through their equity interests) to direct the activities of the entity that most significantly impact its economic performance.

When determining whether Characteristic 2 is present for entities other than limited partnerships, the following tasks should be performed:

- Identify the capital contributions (i.e., equity investments) that qualify as equity investment at risk.
- Group those equity investments together as if they were held by a single party.
- Identify the entity's most significant activities. This analysis should focus on those activities that *significantly* impact the entity's economic performance.
- Evaluate whether the holders of equity at risk, as a group, have the power, through voting rights or similar rights, to direct the entity's most significant activities.
- If decision making has been outsourced to one of the at-risk equity investors through a separate variable interest that does not qualify as equity at risk, determine whether the decision-making rights conveyed through that other variable interest are embedded in the investor's equity investment.
- If the holders of equity at risk, as a group, lack rights that constrain the decision maker's level of authority, consider whether a single party has substantive kick-out or participating rights over the decision maker.

4.4.1.1 **How to evaluate whether the equity holders as a group lack power**

Determining which activities most significantly impact the entity's economic performance requires judgment. When an entity's operations are straightforward or one dimensional, determining whether or not the holders of the equity investment at risk meet the power criterion may not require significant judgment.

In other cases, this analysis may not be so clear cut. The identification of the entity's significant activities may require consideration of the entity's purpose and design, specifically, the nature of the entity's activities and the risks it was designed to create and pass along to its variable interest holders. Reporting entities should carefully review the entity's governing documents, contractual arrangements the entity has entered into, the entity's website and/or promotional materials describing the nature of its operations, as well as the terms of the interests it has issued to its investors. A careful review of these arrangements should facilitate the identification of the potential VIE's significant activities as well as the party that has the power to direct those activities.

4.4.1.2 **Identifying an entity's most significant activities**

Identifying the activities of a potential VIE that most significantly impact its economic performance, and assessing how decisions related to those activities could affect the economic performance of the entity, is critical when assessing whether Characteristic 2 is present. Once the entity's significant activities are identified, it is important to determine whether the decisions related to those activities are made by the group of holders of equity at risk or by parties outside of that group.

The identification of an entity's most significant activities should focus on those activities that require decisions to be made that *meaningfully* impact the entity's key operating metrics and/or business strategy. In other words, those decisions should be substantive.

The activities of an entity that most significantly impact an entity's economic performance will vary by industry depending on the nature of the entity's operations. Certain decisions may universally represent a significant activity of an entity, such as negotiating and executing significant acquisitions and strategic alliances, purchasing or selling assets, expanding the entity's service or product offering, selecting management and determining their compensation, establishing, executing and approving capital and operating budgets, and capital financing (i.e., the issuance of debt or equity).

Other significant activities will be heavily influenced by the nature of the entity's operations. The following list provides examples of activities that may represent some of the activities that most significantly impact the economic performance of entities operating within those industries:

Financial services – asset management	<ul style="list-style-type: none"> <input type="checkbox"/> Establishing the entity's investment strategy <input type="checkbox"/> Purchases and sales of underlying investments <input type="checkbox"/> Exercising voting rights over investees <input type="checkbox"/> Negotiating key service provider contracts
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Financial services – securitization vehicles	<ul style="list-style-type: none"> □ Identifying, negotiating, and purchasing assets held as collateral □ Servicing or “working out” loans or other assets held as collateral that are delinquent or in default
Financial services – banking	<ul style="list-style-type: none"> □ Extending credit / lending standards □ Decisions to extend loans to borrowers □ Investing surplus cash □ Establishing and executing the risk management strategy of the bank □ Servicing or “working out” loans or other assets held as collateral that are delinquent or in default
Financial services – insurance	<ul style="list-style-type: none"> □ Underwriting insurance policies □ Ceding insurance to reinsurers □ Investing net written premiums received
Broadcasting (television and radio)	<ul style="list-style-type: none"> □ Negotiating retransmission agreements □ Programming □ Advertising
BioPharma and technology	<ul style="list-style-type: none"> □ Varies depending upon the phase of the entity’s life cycle, although the significant activities over the entity’s life may be: <ul style="list-style-type: none"> ○ Research and development ○ Sales and marketing (i.e., commercialization of approved drug compounds / biologics / new technologies) ○ Manufacturing of the drug, biologic, or technology □ The power assessment may require a reporting entity to consider whether the stages of the entity’s life cycle are sequenced and dependent upon each other (i.e., whether there is uncertainty around the entity’s ability to progress from one stage of its life cycle to another) □ If the stages of its life cycle are dependent upon one another, the entity’s most important activities will change as it progresses through its life cycle
Retail, consumer and industrial products	<ul style="list-style-type: none"> □ New product development □ Negotiating supply contracts □ Manufacturing (e.g., determining quantities of product sold and sourcing of raw material / inputs to production) □ Sales and marketing

Healthcare (provider)	<ul style="list-style-type: none"> <input type="checkbox"/> Negotiating provider and payor contracts <input type="checkbox"/> Employment and compensation decisions (both clinical and non-clinical) <input type="checkbox"/> Establishing patient care policies and protocol <input type="checkbox"/> Providing patient care
Real estate (leasing)	<ul style="list-style-type: none"> <input type="checkbox"/> Selection of tenants <input type="checkbox"/> Establishing lease terms, including rental rates <input type="checkbox"/> Maintaining the property <input type="checkbox"/> Capital expenditures <input type="checkbox"/> Managing the residual value of the property
Power and utilities (power plants)	<ul style="list-style-type: none"> <input type="checkbox"/> Varies depending upon the phase of the power plant's life cycle (refer to UP 10.4.1.2)

The list presented above is not all inclusive and is intended to provide examples of activities that may significantly impact an entity's economic performance. Reporting entities should evaluate the specific facts and circumstances of each individual situation when identifying a potential VIE's significant activities.

Decisions that are purely administrative in nature should not be considered a significant activity of an entity. Back office functions that do not meaningfully impact an entity's overall performance generally should not be considered a significant activity of a potential VIE. For example, accounting, information technology, and human resource functions would generally not be considered a significant activity of a normal operating entity when determining whether the group of at-risk equity investors has the power to direct the entity's most significant activities.

4.4.1.3 Evaluating entities with limited ongoing decision making

Sometimes an entity's activities are predetermined at formation and the level of ongoing decision making required is limited. Determining whether such entities are VIEs requires careful consideration of the relevant facts and circumstances, including the entity's purpose and design.

If the entity's ongoing decisions are purely administrative in nature, we believe Characteristic 2 would not be present since the group of at-risk equity investors predetermined the entity's significant activities at formation. Even if the ongoing decisions are made through a variable interest that does not qualify as equity at risk, Characteristic 2 would not be present if those ongoing decisions are insignificant or administrative. In that situation, the decision maker would be unable to direct a single activity of the potential VIE that *significantly* impacts its economic performance.

When the entity's ongoing decisions are other than purely administrative, we believe the identity of the party directing those activities and the means through which it exercises decision making becomes increasingly relevant. If those ongoing decisions are directed through a variable interest that does not qualify as equity at risk (refer to CG 4.4.1.4), the nature of the ongoing decisions made by the holder of

that variable interest should be carefully considered to determine whether the group of at-risk equity investors lack power.

4.4.1.4 Decision making must reside within the equity instrument

Excerpt from ASC 810-10-15-14(b)

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.

In some circumstances, a holder of equity at risk may have the ability to make decisions through another variable interest (e.g., decision making arrangement, such as a management contract) as opposed to an at-risk equity investment. If these decisions are made through another variable interest as opposed to the decision maker's at-risk equity investment, then depending on the facts those rights may not be attributed to the group of at-risk equity investors for purposes of assessing whether Characteristic 2 is present. Consequently, the entity may be considered a VIE.

Determining whether decision making rights are held by the group of holders of equity at risk can be difficult, particularly when one of the equity investors has entered into a separate contractual arrangement with the potential VIE that conveys decision making rights. If the decision maker can sell its equity interest to an unrelated third party, it should consider whether the buyer (transferee) would also be required to purchase or assume the reporting entity's other variable interest (the decision making arrangement). In other words, the decision maker should determine whether the variable interest that conveys decision making is legally detachable from its at-risk equity investment.

If the other variable interest (e.g., decision maker contract) can be legally separated from the decision maker's equity investment, we believe the contractual arrangement and at-risk equity investment should be evaluated as two distinct interests. To make this determination, a reporting entity should consider whether it is possible for the decision maker to transfer its equity interest without also transferring its other variable interest that conveys decision making rights. If it is not legally possible to separate the variable interests, then the power to direct the entity's most significant activities may reside within the group of at risk equity investors. In other words, the decisions making rights exercisable through its other variable interest may be viewed as though they are exercised through the decision maker's equity interest (i.e., the contractual arrangement would be considered part of the decision maker's equity interest). Consequently, no decision making exception would be present and the entity would not be a VIE with respect to Characteristic 2.

If the two variable interests are legally separable and decision making is exercisable through the contractual arrangement, further analysis is required to determine whether the entity is a VIE under Characteristic 2. This would require consideration of the rights exercisable by the potential VIE's at-risk equity investors. Refer to CG 4.4.2 for further details on outsourced decision making for corporations and similar entities.

4.4.2 Outsourced decision making – corporations and similar entities

If a variable interest that is outside the equity investment at risk (e.g., debt interests, management contracts and equity investments that do not qualify as equity at risk) provides the holder of that

interest with the power to direct the activities that most significantly impact the potential VIE's economic performance, then Characteristic 2 may be present and the entity could be considered a VIE.

ASU 2015-02, *Consolidation – Amendments to the Consolidation Analysis* changed the evaluation of whether the at-risk equity investors (as a group) lack power when decision making is outsourced through a variable interest that does not qualify as equity at risk. In particular, the changes apply if there is a single decision maker that has a variable interest that is separate from (not embedded in) a substantive at-risk equity investment that conveys the power to direct the entity's most significant activities. If the interest conveying decision making is not a variable interest, then the group of at-risk equity investors are presumed to have the power to direct the entity's most significant activities and Characteristic 2 would not be present.

The change in how outsourced activities should be assessed resulted from the FASB's consideration during the redeliberations of ASU 2015-02 of whether a registered mutual fund should be a VIE. Prior to the issuance of ASU 2015-02, a registered mutual fund would have been considered a VIE under the "power" and "economics" version of the VIE model if (1) an outsourced decision maker had power through a variable interest that was not embedded in an at-risk equity investment, and (2) substantive kick-out or participating rights exercisable by a single party did not exist.

The FASB considered the rights exercisable by the shareholders and board of directors of a mutual fund that is registered in accordance with the Investment Company Act of 1940 and determined that these entities should generally be considered voting interest entities. Specifically, the FASB noted that the rights exercisable by a registered mutual fund's shareholders, either directly or indirectly through the entity's independent board of directors, are not substantively different from voting rights held by shareholders of a public company (which are generally not VIEs).

The new approach introduced by ASU 2015-02 shifts the focus from single party kick-out or participating rights to the rights that the entity's shareholders can exercise in the aggregate. If such rights exist and are substantive, it is presumed that the shareholders can constrain the outsourced decision maker's level of discretion and decision making authority. Application of this approach may result in the conclusion that the shareholders, rather than the outsourced decisions maker (e.g., manager), have the power to direct an entity's most significant activities.

Although this concept was discussed in the context of a registered mutual fund, it applies to all entities that outsource decision making through variable interests that do not qualify as equity at risk (e.g., management contracts or equity interests that do not qualify as equity at risk). This approach should not be applied to limited partnerships and similar entities as those entities are subject to the separate requirement described in ASC 810-10-15-14(b)(1)(ii).

The approach described in ASC 810-10-15-14(b)(1)(i), which applies to entities that are *not* limited partnerships or similar entities, can be summarized in the following three steps.

Step 1: determine if the decision-making fee arrangement is a variable interest

If the decision-making fee arrangement is not a variable interest, then the equity investors as a group do not lack the power to direct the activities of the entity that most significantly impact its economic performance. The nature of that arrangement would indicate that the decision maker is acting in a fiduciary (agent) capacity and is therefore presumed to lack power over the entity's most significant activities. This is because the decision maker will act in a manner that is primarily for the benefit of the entity's equity investors. As a result, the entity would not be a VIE under Characteristic 2 and steps

two and three would not apply.

Example CG 4-8 illustrates the assessment of the impact of a decision-making fee arrangement that is not a variable interest.

EXAMPLE CG 4-8

Assessing the impact of a decision-making fee arrangement that is not a variable interest

Entity ABC owns and operates data centers in several locations. The data centers house their customers' servers, provide internet connectivity, and are contractually committed to have the servers operational for 99.97% of the time. Otherwise, Entity ABC would be subject to payment of heavy penalties.

Company A provides maintenance services to Entity ABC that are critical to the data center's operations. Under the maintenance arrangement, Company A makes all decisions related to the maintenance of the data centers and keeps them operational pursuant to the contractual requirements. Company A has no other interest in the entity.

The maintenance arrangement meets all the conditions in ASC 810-10-55-37 such that the maintenance fee paid to Company A is not a variable interest (i.e., Company A's fee is at market, commensurate, and Company A has no other economic interests directly or indirectly through its related parties that are more than insignificant).

What is the impact of Company A's ability to make decisions through its service provider arrangement?

Analysis

In this example, even though Company A makes critical decisions that have a significant impact on the performance of Entity ABC, the maintenance fee is not a variable interest and Entity ABC would not be a VIE under Characteristic 2. If a decision maker or service provider contract is not a variable interest (see CG 3.4), then the decision maker or service provider is acting as an agent of the group of holders of equity at risk and would not have the power to direct Entity ABC's most significant activities.

Step 2: determine if there is a unilateral kick-out or participating right

If the decision-making fee arrangement is a variable interest under the first step, then the reporting entity should consider whether substantive kick-out or participating rights exist. If a substantive right to replace the decision maker or veto (block) *all* of the entity's most significant activities exists, then the entity would not be a VIE under Characteristic 2 and step 3 would not apply.

For the purposes of assessing whether a kick-out right or participating rights are substantive when evaluating an entity that is not a limited partnership or similar entity, kick-out rights (which also include liquidation rights) and participating rights should be ignored unless those rights can be exercised by a single party (including its related parties and de facto agents).

Step 3: assess the rights of shareholders

If the decision-making fee is determined to be a variable interest pursuant to ASC 810-10-55-37, and single party kick-out or participating rights do not exist, then the rights held by the entity's equity investors must be considered to determine whether the at risk equity investors, as a group, lack the power to direct the entity's most significant activities. Prior to the issuance of ASU 2015-02, the group of at risk equity investors was not considered to have power if a decision maker exercised power over the entity's most significant activities through a variable interest that did not qualify as equity at risk. In such circumstances, the entity was determined to be a VIE under Characteristic 2 unless a single party (including its related parties and de facto agents) could exercise a substantive kick-out or participating right.

ASU 2015-02 introduced a new approach requiring a reporting entity to first consider the rights exercisable by the holders of equity at risk if substantive single party kick-out or participating rights do not exist. This additional step is required only when decision making over an entity's most significant activities has been conveyed through a variable interest that does not qualify as equity investment at risk and single party kick-out or participating rights do not exist. If the at risk equity investors have certain rights as shareholders of the entity, then the entity would not be a VIE.

ASC 810-10-55-8A provides an example to illustrate the types of rights that may suggest the holders of equity at risk, as a group, have decision making power over the entity's most significant activities. The example is written in the context of a series mutual fund and points to various shareholder rights as being present, including the ability to remove and replace the board members and the decision maker, and to vote on the decision maker's compensation. It should also be noted that ASU 2015-02's basis for conclusions (BC36) notes that this concept is intended to be applied broadly to all entities other than limited partnerships and similar entities.

Example CG 4-9 illustrates the application of this concept in a non-fund scenario.

EXAMPLE CG 4-9**Determining whether rights held by an entity's shareholders convey power**

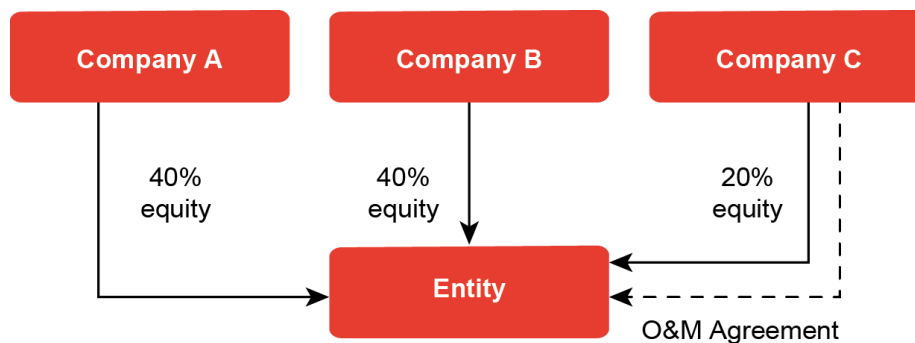
Three unrelated companies established an entity to invest in shipping vessels. Company A and B each provide 40% of the capital in exchange for equity interests, and Company C also provides capital in exchange for a 20% equity interest. The entity operates subject to the supervision and authority of its board of directors. Each party has the ability to appoint members to serve on the entity's board and shares in the entity's profits and losses in proportion to their respective ownership interests.

The purpose, objective, and strategy of the entity is established at inception and agreed upon by its shareholders pursuant to the entity's formation agreements. The three companies identified and jointly agreed to the specified shipping vessels in which the entity would invest at formation.

Company C performs all of the daily operating and maintenance activities over the shipping vessels pursuant to an Operating and Maintenance (O&M) agreement. The decisions relating to the operation and maintenance of the vessels are determined to be activities of the entity that most significantly impact the entity's economic performance. Company C receives a fixed annual fee for services provided to the entity that is at market and commensurate. However, the fee arrangement is determined to be a variable interest because Company C has another significant variable interest in the entity (its 20% equity investment).

A number of decisions require simple majority board approval. These include:

- The removal and replacement of the O&M manager, without cause
- Changes in the O&M manager's compensation
- The acquisition of new ships
- The sale of existing ships
- A merger and/or reorganization of the entity
- The liquidation or dissolution of the entity
- Amendments to the entity's charter and by-laws
- Increasing the entity's authorized number of common shares
- Approval of the entity's periodic operating and capital budgets



Do the holders of equity at risk, as a group, lack the power to direct the entity's most significant activities (is the entity a VIE under Characteristic 2)?

Analysis

Notwithstanding the fact that the decision-making fee arrangement is a variable interest, the entity would not be considered a VIE. The board is actively involved in making decisions about the activities that most significantly impact the entity's economic performance. Among other rights, the board is able to remove the O&M manager without cause and approve its compensation. As the board is elected by the shareholders and is acting on their behalf, the shareholders in effect have power to direct the activities that most significantly impact the economic performance of the entity. Accordingly, the entity would not be a VIE under Characteristic 2.

If the board was non-substantive or lacked the legal authority to bind the entity, then the rights exercisable by the board would be less relevant. In that situation, the rights exercisable directly by the holders of equity at risk would determine whether the group lacks power.

Determining which shareholder rights must exist to demonstrate that Characteristic 2 is not present will depend on the relevant facts and circumstances, including the purpose and design of the entity. If

an entity has a substantive board of directors, and the board is actively involved in overseeing the business and can legally bind the entity, we believe the at risk equity investors must have the ability to replace the board to demonstrate that they have power unless they have the substantive ability to *directly* exercise the same rights held by the board.

If an entity is not governed by a board of directors, or is governed by a board of directors that cannot legally bind the entity, then rights exercisable by the board become less relevant to this analysis. In those circumstances, rights exercisable by the shareholders (directly) should be assessed to determine whether they enable the holders of equity at risk, as a group, to constrain the outsourced decision maker's level of authority and decision making.

Example CG 4-10 illustrates the determination of whether an at risk equity investor has power through an outsourced decision making arrangement.

EXAMPLE CG 4-10

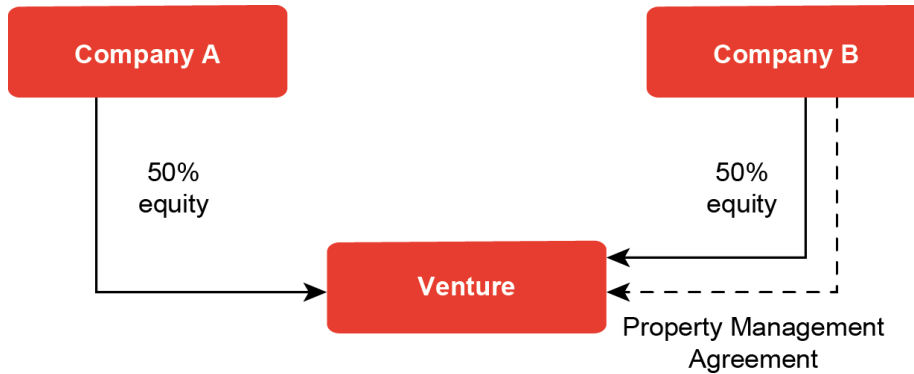
Determining whether an at risk equity investor has power through an outsourced decision making arrangement

Two unrelated parties, Company A and Company B, form a real estate operating joint venture, with each party holding a 50% interest. The venture's objective is to acquire properties, lease the properties to third party tenants, and sell the properties on an opportunistic basis.

The venture will be governed by a board of directors (the Board), and Company A and Company B will each be entitled to appoint three of the Board's six directors. The Board will act through a simple majority vote and in the event of a deadlock, a dispute resolution mechanism will take effect to resolve the issue (binding arbitration).

The Board executed a property management agreement with Company B giving Company B the ability to unilaterally direct leasing, maintenance, tenant selection, and remarketing activities related to the properties owned by the venture (the venture's most significant activities). The agreement has an initial one-year term and will automatically renew for successive one-year periods unless Company B or the Board elect not to renew the contract. In exchange for services provided, Company B will be entitled to an annual management fee and performance incentive fee entitling Company B to 15% of the venture's profits once the investors achieve a 15% internal rate of return on their capital contributions. Otherwise, Company A and Company B will share in the profits and losses of the venture proportionately.

Notwithstanding the fact that the fee arrangement is at market and commensurate, Company B's property management agreement is a separate variable interest given Company B's other significant economic interest (i.e., its 50% equity interest). The decision making rights exercisable by Company B pursuant to the property management agreement were determined to be separate from its 50% equity investment (i.e., they are not embedded).



As shareholders of the venture, Company A and Company B have the ability to make the following decisions through a simple majority vote:

- Terminate the property management agreement
- Approve changes in Company B's compensation
- Approve a sale of substantially all of the venture's assets
- Liquidate the venture
- Approve a change in control of the venture
- Approve a change in the name of the venture
- Approve the venture's accounting firm

As Company B directs the venture's most significant activities through a variable interest that does not qualify as equity at risk, the shareholder rights exercisable by Company A and Company B must be assessed to determine whether Company B, as property manager, or the group of at risk equity investors have the power to direct the venture's most significant activities.

Does the venture's group of at risk equity investors lack the power to direct the activities that most significant impact its economic performance?

Analysis

Yes. Although Company A and Company B have the ability to exercise the rights described above as equity investors of the venture, such rights are not sufficient to demonstrate that the group of at risk equity investors have power. At minimum, the equity at risk must have the ability to remove the property manager, remove the Board (since the Board appears substantive), and approve changes in Company B's property management agreement, including compensation, to demonstrate that the group has power.

In this fact pattern, Company A and B can each replace their designated Board representatives, and Company A has the ability to withhold its consent to change Company B's compensation. However, the group's ability to terminate the property management agreement requires the consent of Company B, the property manager. Because Company B, as an equity investor, has the ability to prevent the group

of at risk equity investors from terminating Company B's property management agreement, this kick-out right is not substantive. Accordingly, rights exercisable by Company A and Company B (as at risk equity investors) are not sufficient to demonstrate that the holders of equity at risk, as a group, have the power to direct the venture's most significant activities.

If Company A does not have the unilateral, substantive right to kick-out Company B as property manager, liquidate the venture, or exercise participating rights, then Characteristic 2 would be present and the venture would be a VIE under ASC 810-10-15-14(b)(1)(ii).

The existence of shareholder rights alone is not sufficient to demonstrate that the holders of equity at risk, as a group, have the power to direct the activities of the potential VIE that most significantly impact its economic performance. A reporting entity should also consider whether such rights are substantive.

Determining whether shareholder rights are substantive requires careful consideration of an entity's governing documents and may also require an understanding of state law in which the potential VIE is domiciled. Consultation with internal or external legal counsel may be prudent in those situations.

The guidance does not specifically state that these rights must be substantive in order to demonstrate that the at risk equity investors have power. However, we believe non-substantive shareholder rights should not drive the reporting entity's assessment of whether Characteristic 2 is present. We believe the rights exercisable by the holders of equity at risk, as a group, must be substantive to demonstrate that they have the power to direct the activities of the potential VIE that most significantly impact its economic performance.

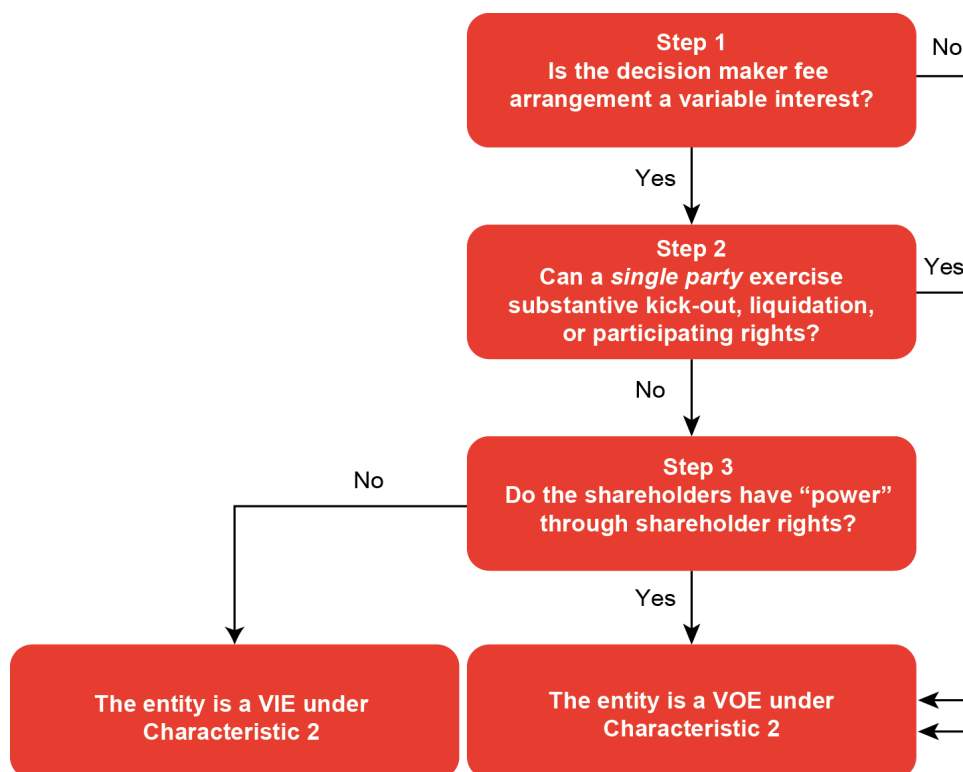
To be substantive, we believe the group of at risk equity investors must have the ability to exercise such rights implicitly or explicitly. For example, the following may indicate that the rights held by the at risk equity investors are non-substantive:

- The potential VIE is not required to hold an annual meeting
- There is no mechanism for the shareholder group to obtain the identities of the other shareholders and/or convene a general meeting to exercise such rights
- Exercising such rights requires a supermajority vote of the investors as opposed to simple majority vote or lower threshold
- The decision maker holds an equity investment in the entity and can prevent the unrelated at risk equity investors from terminating its decision making arrangement

Figure CG 4-2 includes a decision tree for this characteristic applicable to entities that are not limited partnerships or similar entities:

Figure CG 4-2

Decision tree for Characteristic 2 applicable to entities that are not limited partnerships or similar entities



4.4.3 Other outsourced decision-making considerations

In addition to the general considerations discussed in CG 4.4.2 for outsourced decision-making arrangements, certain structures or contractual arrangements may require further analysis to determine if Characteristic 2 is present.

4.4.3.1 Equity investments with “super” voting rights

Super voting common stock may give a shareholder with less than a majority of the economic interests in an entity control over that entity. This would not cause that entity to be a VIE under Characteristic 2 provided that the super voting common stock is considered equity at risk.

If, however, a shareholder with less than a majority of the economic interests in an entity obtained control of that entity through a management contract, and those rights are not included in the terms of the super voting common shares, then that entity might be considered a VIE absent (1) rights exercisable by the holders of equity at risk, directly or indirectly, that demonstrate that the group does *not* lack power, or (2) substantive single party kick-out or participating rights. Super voting rights may indicate that there are disproportionate voting rights that would cause the entity to be a VIE under Characteristic 3. See CG 4.5 for further details on Characteristic 3.

4.4.3.2 **Shareholder agreements**

An entity's equity investors may enter into a separate contractual arrangement that transfers voting rights. If decision making is determined by a shareholder agreement, and all parties to the shareholder agreement are holders of equity investment at risk, we believe the entity would not be considered a VIE due to the voting arrangement. Such arrangements represent a transfer of voting rights among the group of at risk equity investors, and therefore decision making continues to reside within the group of at risk equity investors.

If an equity investor is granted power over the entity through a shareholder agreement, and that equity investor's interest does not qualify as equity at risk, then decision making would be outside the equity investment at risk and Characteristic 2 would be present.

4.4.3.3 **Participating rights - outside of the equity investments at risk**

If substantive participating rights are held by parties other than the holders of the equity at risk, such as a lessee or a lender, it would be difficult to conclude that the group of at risk equity investors has power over the entity's most significant activities.

For example, if a lender has the ability to veto operating and capital decisions (including decisions that establish an entity's budgets) and the entity does not have the right or ability to refinance its debt, substantive decision-making ability may not rest with the group of holders of equity at risk. As a result, Characteristic 2 would be present and the entity would likely be considered a VIE.

Example CG 4-11 illustrates evaluation of the impact of participating rights held outside the group of holders of equity at risk.

EXAMPLE CG 4-11

Evaluating the impact of participating rights held outside the group of holders of equity at risk

Entity XYZ owns and operates a theme park. Assume that the decisions that most significantly impact the performance of the entity include maintaining and efficiently operating the existing rides and making capital investments (i.e., incurring capital expenditure for new rides to attract visitors to the theme park). Entity XYZ typically funds its capital investments via a mix of equity and debt financing. However, all capital investment decisions involving new rides require the lender's approval (one lender), as the new rides are collateral for the debt financing. The lender's approval of the expenditure for the new ride is considered part of its standard loan underwriting requirements.

Does the lender's ability to approve capital investment decisions financed by the lender cause Entity XYZ to be a VIE under Characteristic 2?

Analysis

No. The lender's approval of the expenditure for the new ride is a requirement for securing the debt financing from the lender and is part of the lender's standard loan underwriting requirements. This type of underwriting requirement is typical in many collateral lending arrangements where the lender approves the project that the funds will be used for. From the lender's perspective, the approval right is a protective right to ensure repayment of the financing.

On the other hand, if the lender was approving Entity XYZ's annual operating budgets each year the loan was outstanding, Entity XYZ would likely be considered a VIE under Characteristic 2 since such rights are not typical in loan agreements and the lender can exercise a participating right over an activity of the entity that most significantly impacts its economic performance.

Characteristic 2 may also be present when a party outside the group of at risk equity investors has substantive participating rights. Because the group of at risk equity investors cannot exercise power, the entity would be VIE under ASC 810-10-15-14(b)(1)(ii).

4.4.3.4 *Nominee shareholder arrangements*

Many reporting entities use nominee shareholders in order to facilitate the consolidation of certain entities. The guidance for nominee shareholders is described in ASC 810-10-20 and 10-25 (see CG 7.4.1). While the guidance was issued to address the consolidation of physician practices by physician practice management entities, the guidance is also relevant to many other entities that utilize nominee shareholders.

Entities that utilize nominee shareholders will likely be VIEs because the entities generally do not have sufficient equity at risk and non-equity holders at risk generally have decision making ability. Examples of structures utilizing nominee shareholders may include: physician practice management arrangements, ownership of entities located in foreign countries that restrict foreign ownership, and local management arrangements in the broadcasting industry. The following example illustrates how a nominee shareholder arrangement may be established.

Assume a foreign investor wishes to acquire an entity located in an Asian country that restricts foreign ownership. In order to effect the acquisition, the foreign investor and the selling shareholder of the Asian entity enter into a contractual arrangement. Under the terms of the contractual arrangement, (1) the foreign investor acquires, for cash, the contractual right to the economic equity interest in the Asian entity from the selling shareholder, (2) the selling shareholder remains the sole legal shareholder of the Asian entity, and (3) the foreign investor retains the right to replace the legal shareholder of the Asian entity at any time by acquiring the shares of the Asian entity from the legal shareholder for a nominal amount, thus effectively retaining all the rights and privileges (voting, dividends, etc.) of the shares of the Asian entity as if it were the legal shareholder of the Asian entity.

Since the requirements for a nominee shareholder are met, as described in ASC 810-10-20 and 10-25, the legal shareholder of the Asian entity would be considered a nominee shareholder of the foreign investor. Generally, the foreign investor, the selling shareholder, and the Asian entity would enter into additional contracts at the same time of the nominee shareholder arrangement, which usually results in the foreign investor consolidating the Asian entity. These additional contracts may include a shareholder voting rights proxy agreement, an equity pledge agreement, and an exclusive business cooperation agreement, among others.

4.4.3.5 *Special considerations*

Physician practices and other entities often controlled by contract and franchise agreements may require special consideration. Although physician practice management entities are often VIEs, the applicable guidance is discussed in the literature in the context of the VOE model. See CG 7.4 for information on physician practice management entities.

4.4.4 *Franchise business models*

The use of franchises is prevalent in the retail and consumer industry. In a typical franchise arrangement, a company will license the right to use its name, trademarks, and general operating philosophies and practices to individuals or entities in varying geographic regions. The franchisor will allow the operator (franchisee) to use its trademark and distribute goods or provide services in exchange for a royalty or franchise fee. The franchisor typically retains responsibility for regional or national advertising, and negotiates terms with approved vendors from whom the franchisees are required to purchase their raw materials. In doing so, the franchisor creates synergies in the form of cost reductions and broad-based marketing that is intended to benefit the franchisee group as a whole.

Franchise agreements differ greatly from company to company, and a careful analysis of these arrangements is necessary to determine whether the franchisor has rights that cause the franchisee to be a VIE under Characteristic 2.

Franchise agreements typically require a franchisee to strictly adhere to specific, standardized operating protocols. In many cases, the franchisor's policies and procedures stipulate the following:

- Policies and procedures for running the business, including personnel policies
- That the owner of the franchise location, as well as the franchisee's employees, must be trained by the franchisor
- Usage of the franchisee's logo or trademark
- Usage of the franchise location's store and appearance
- Uniforms to be worn by employees
- Hours of operation
- Procurement and supply of raw materials
- The territory in which the franchisee is authorized to operate within

Although the stipulations imposed by a franchisor may, on the surface, appear to limit the franchisee's ability to operate autonomously, they do not necessarily cause the franchisee to be a VIE under Characteristic 2. In most cases, franchisees are required to conform to stipulations imposed by the franchisor to ensure the quality of the franchisor's products or services is uniform and consistent across all locations. That is, the requirements imposed by the franchisor are generally intended to protect the value of the franchisor's brand (i.e., the franchisor's rights are protective in nature) as opposed to allow the franchisor to exercise power. The ability of any party to exercise protective rights does not cause an entity to be a VIE under Characteristic 2.

Conversely, if the stipulations imposed by the franchisor are designed to enable the franchisor to control the franchisee's operations, then Characteristic 2 may be present and the franchisee may be a VIE. The determination of whether a franchisor's rights are protective in nature can be judgmental and requires careful consideration of the relevant facts and circumstances.

Since many of the franchisee’s activities are predetermined by the franchise agreement, the focus of this analysis should shift to the franchisee’s activities that the holders of equity at risk can direct. This analysis should not consider decisions that are administrative or inconsequential as those decisions pertain to activities of the entity that do not significantly impact the entity’s economic performance.

We believe a franchisee may have the power to direct the franchisee’s most significant economic activities when (1) the stipulations imposed by the franchisor are designed to protect its brand, rather than to convey power over its franchisee’s most significant activities, and (2) the franchisee has the discretion to make all other important decisions impacting the economic performance of the franchisee, such as:

- The daily delivery of quality products or services to customers
- Establishing and executing capital and operating budgets
- Execution of the franchisor’s operating systems
- Establishing the pricing of products or services sold at the franchise location
- Hiring, scheduling, terminating, and setting the compensation of the franchise’s employees

In addition, we believe the fact that the franchisee voluntarily agreed to operate the business in accordance with the franchisor’s established rules and regulations may demonstrate that the holders of equity at risk, as a group, have power. That is, the success or failure of the franchisee primarily rests with the franchisee’s owners as opposed to the franchisor. The list described above is not all inclusive and the facts and circumstances specific to each franchisee should be carefully considered.

Situations where a franchisor extends a loan or owns equity in a franchisee should be closely evaluated to determine whether the franchisee or the franchisor has the power to direct the franchisee’s most significant activities. As the level of economics held by the franchise owners decreases, the ability of the owner of the franchisee to exercise power over the entity’s economically significant activities should be evaluated with skepticism. Conversely, as the franchisor’s level of economic ownership in a franchisee increases, the likelihood that its decision making rights have migrated from protecting its brand to impacting the economic performance of that franchise location will increase.

4.4.5 *Applying Characteristic 2 to LP’s and similar entities*

A separate analysis is required for applying Characteristic 2 to limited partnerships and similar entities due to the unique purpose and design of limited partnerships as compared to corporations. Entities that are determined to be “similar” to limited partnerships would also be subject to this guidance. For example, some entities may be similar to a limited partnership if they have a governance structure that is the functional equivalent of a limited partnership’s governance structure.

Excerpt from ASC 810-10-15-14(b)(1)

- 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.

Understanding the principle behind this guidance requires consideration of the differences between a limited partnership and a traditional corporation. A corporation's shareholders generally have voting rights that provide them with the power to direct the entity's most significant activities. Although the corporation's management team executes the day-to-day decisions, the voting rights held by the corporation's shareholders allow the shareholders to limit or constrain the management team's decision-making authority.

In contrast, the general partner of a limited partnership often unilaterally directs the activities of a limited partnership that most significantly impact the entity's economic performance. Although the limited partners generally lack voting rights consistent with those rights typically held by corporate shareholders, they may have other rights that allow them to effectively constrain the general partner's decision making authority. Determining whether these rights exist is critical to assessing whether a limited partnership or similar entity is a VIE under Characteristic 2.

The limited partnership (or similar entity) would not be a VIE under Characteristic 2 if the limited partners are able to exercise power in either of the following ways:

- A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk can exercise substantive kick-out rights
- Limited partners with equity at risk can exercise substantive participating rights

Any of these rights, if present, are considered analogous to voting rights held by corporate shareholders that provide those shareholders with power over the entity being evaluated for consolidation. In other words, for a limited partnership (or similar entity) to be a voting interest entity, the limited partners (or members of a limited liability company that is similar to a limited partnership) must have, at minimum, substantive kick-out or participating rights.

4.4.5.1 *Evaluating whether an entity is similar to a limited partnership*

To understand whether an entity's governance structure is similar to a limited partnership, an analysis should be performed based on the facts and circumstances specific to that entity's formation and governing documents. For example, a limited liability company that is governed by a managing

member, as opposed to a board of managers, may be similar to a limited partnership. The evaluation of a limited liability company should consider whether a managing member has sole decision-making authority, similar to the rights held by the general partner of a limited partnership.

Question CG 4-3

Should the separate requirement described in ASC 810-10-15-14(b)(1)(ii) for limited partnerships and similar entities be applied when evaluating whether a trust is a VIE under Characteristic 2?

PwC response

It depends. If the trust is governed by a single trustee that has been granted all day-to-day decision-making abilities, then application of the separate requirement for limited partnerships and similar entities may be appropriate. In that situation, the trustee may be acting in a capacity that is no different from a general partner of a limited partnership.

If the trust is governed by a board of trustees that has the legal ability to make decisions and bind the trust, and the trustee is simply acting as an agent of the trust's board, then application of the separate requirement applicable to limited partnerships and similar entities may be inappropriate.

Determining whether a trust is governed by a single trustee or a governing body that is similar to a board of directors requires a review of the trust's governing documents. If a board of trustees exists, it is important to understand whether the board's decision-making rights are limited to advising the trustee as opposed to having the legal authority to bind the trust. If the board's role is limited to advising the trustee (i.e., it cannot bind the trust), then application of the separate requirement for limited partnerships and similar entities may be appropriate.

A limited liability company may be governed by a board of members as opposed to a managing member. Much like a corporation's board of directors, the entity's board of members votes on all significant decisions impacting the limited liability company's activities. An evaluation of the limited liability company might consider whether the members have capital accounts similar to limited partners of a limited partnership. This analysis would also take into account what decision-making rights have been granted to the members and how their voting rights are exercised.

Example CG 4-12 demonstrate the determination of whether a limited liability company is similar to a limited partnership.

EXAMPLE CG 4-12

Determining whether a limited liability company is similar to a limited partnership

Company A established a limited liability company (LLC Corp) for the purpose of raising third-party capital to invest in private companies. LLC Corp's objective is to obtain controlling positions in private companies, improve the performance of the businesses, and liquidate its position within seven years. The third-party investors are issued member interests in LLC Corp in exchange for their capital contributions. Each member has a separate capital account, and LLC Corp's profits and losses are allocated among the members based on their proportionate ownership of the LLC's member interests.

LLC Corp is presided over by Company A (the Managing Member). In accordance with LLC Corp's governance agreements, Company A makes all decisions related to LLC Corp's investment strategy and makes decisions pertaining to the acquisition and disposition of LLC Corp's investments. Company A established an independent committee (the Investment Committee) comprised of certain members to advise Company A. The Investment Committee generally cannot bind LLC Corp as its role is advisory in nature. However, the Investment Committee can vote on transactions involving Company A and its affiliates when a conflict of interest may exist. The members of LLC Corp are not otherwise able to exercise any voting rights.

For purposes of applying Characteristic 2, should LLC Corp be evaluated as a limited partnership or as a corporation?

Analysis

We believe that if a managing member has the right to make the significant decisions of the LLC, the LLC would be considered to have governing provisions that are the functional equivalent of a limited partnership. This is the case even if the non-managing members have participating rights or kick-out rights. While the ASC guidance states that a managing member of an LLC is the functional equivalent of a general partner, we believe the managing member should also have the right to make the significant decisions of the LLC to be considered the functional equivalent of a limited partnership (versus a managing member who may be more of an operations manager without the right to make the significant decisions of the entity).

In this example, LLC Corp should be evaluated as a limited partnership for purposes of applying Characteristic 2, as the governance agreements provide the managing member with the right to make all the significant decisions of the LLC.

Company A is the only party authorized to make decisions and to bind LLC Corp, similar to a general partner of a limited partnership. Although the Investment Committee exists, it does not operate in a manner similar to a corporation's board of directors. The Investment Committee exists solely to advise Company A and cannot bind the LLC, and its ability to vote on transactions involving Company A and its affiliates is protective in nature and exists solely to prevent self-dealing.

In addition, LLC Corp's members have capital accounts as opposed to ownership units, which also indicates that LLC Corp has attributes that are like a partnership.

4.4.5.2 Kick-out rights

The mere existence of kick-out rights does not necessarily demonstrate that the limited partners have power over the limited partnership (or similar entity). The kick-out rights must be substantive to demonstrate that the group of at-risk equity investors (i.e., the limited partners) has power. Kick-out rights will be considered substantive only when they are exercisable by a simple majority vote of the entity's limited partners (exclusive of the general partner, parties under common control with the general partner, and other parties acting on behalf of the general partner) or a lower threshold (as low as a single limited partner) based on the limited partners' relative voting rights. A limited partner's voting rights are often determined by its relative capital account balance.

The substance of kick-out rights granted to an entity's limited partners may be called into question when there are economic or operational barriers to exercising such rights that must be overcome, for example:

- Conditions that make it unlikely that the rights will be exercised
- Financial penalties or operational barriers that the limited partners would face upon exercise of kick-out rights
- An inadequate number of qualified replacements for the current decision maker, or when the level of compensation paid to the decision maker is inadequate to attract a qualified replacement
- The lack of an explicit mechanism, by matter of contract or law, to allow the holder to exercise the rights or to obtain the information necessary to exercise the rights

The FASB provides further guidance for determining whether kick-out rights constitute a simple majority in several case studies found in ASC 810-10-55-4N, which introduce the concept of the "smallest possible combination." The first step is to identify the smallest combination of limited partner interests that would be considered a simple majority. The next step would be to consider whether that combination meets the voting threshold included in the partnership agreement to remove the general partner. If the smallest combination of limited partner interests that constitute a simple majority also hold enough interests to meet or exceed the voting threshold in the partnership agreement, the kick-out rights would meet the simple majority requirement under ASC 810. If it does not, the kick-out rights would not be considered substantive, and the partnership would be considered a VIE.

For example, assume that a limited partnership agreement requires a 70% vote of the limited partners to remove the general partner, and there are three limited partners with limited partnership interests and voting rights representing 25%, 35%, and 40%. In evaluating the first step described above, a combination of any two of the three limited partners constitutes a simple majority; however, the smallest combination of limited partnership interests that would constitute a simple majority would be the partners holding a 25% and 35% interest, for a combined total of 60%. In applying the second step, one would determine whether the smallest combination of interests (i.e., 60%) would meet or exceed the 70% threshold required in the partnership agreement to remove the GP. Since 60% would fall below the requirement of 70%, the kick-out rights included in the agreement would not be considered substantive and the partnership would be considered a VIE. Alternatively, if the threshold provided in the partnership agreement to remove the GP was 50%, the kick-out rights would meet the simple majority requirement under ASC 810.

As noted above, ASC 810-10-55-4N provides more example that illustrate this concept.

It is important to note that the general partner's interests and rights may impact this assessment as well. The simple majority assessment in ASC 810 only includes the votes of the limited partners unrelated to the general partner. In other words, when one is determining the smallest possible combination of limited partners (unrelated to the general partner) that constitute a simple majority, the denominator should be adjusted to remove the voting rights held by the general partner or limited partners that are related to the general partner.

For example, assume the general partner owns a 10% interest in the limited partnership and all partners are permitted to vote on the removal of the general partner in proportion to their ownership

interests. Further, assume that the LP interests are owned by 90 limited partners, all unrelated to the general partner, each with a 1% ownership interest. In evaluating the first step, a simple majority would be calculated under ASC 810 by adjusting the denominator to remove the 10% interest held by the general partner. As a result, the smallest combination of limited partners to constitute a simple majority of voting interests under ASC 810 would be 46 limited partners or more than 45% of the voting interests (50% of 90%).

In applying the second step, the smallest combination of interests (i.e., 46%) would need to meet or exceed the threshold required in the partnership agreement to remove the GP. If the partnership agreement includes a threshold of 50% of **all** voting interests to remove the general partner, the simple majority requirement in ASC 810 would not be met and the kick-out rights would not be substantive. The same analysis would be required if limited parties that are related to the general partner are entitled to vote on the removal of the general partner.

Question CG 4-4

Does the ability of a general partner and/or its related parties to participate in a vote to kick out the general partner of a limited partnership cause the limited partnership to be a VIE under Characteristic 2?

PwC response

It depends. If a simple majority (or lower threshold) of the unrelated limited partners lack the substantive right to remove the general partner, then the entity would be considered a VIE under Characteristic 2 (assuming the limited partners do not have substantive participating rights). For example, assume an entity has 12 limited partners, 10 of which are unrelated to the general partner and each holds an equal amount of the limited partnership's kick-out rights through voting interests. If the partnership agreement requires a simple majority of the 10 unrelated limited partners to remove the general partner, the limited partners would not lack power and the entity would not be a VIE under Characteristic 2.

On the other hand, if the partnership agreement required a vote of a simple majority of all 12 limited partners (i.e., 7 limited partners) to remove the general partner, this kick-out right would not be substantive. In this case, the kick-out right lacks substance because it requires a higher percentage (70% or 7 of 10 limited partners) than a simple majority of the unrelated limited partners (6 of 10 limited partners would be a simple majority) to effect the removal of the general partner. Assuming the limited partners do not have any substantive participating rights, the limited partners would lack power and the entity would be a VIE under Characteristic 2.

Impact of kick-out rights on Characteristic 2

The following examples illustrate the impact of kick-out rights on the assessment of whether an entity is a VIE under Characteristic 2 for limited partnerships.

EXAMPLE CG 4-13**Simple majority kick-out rights exercisable by a single limited partner**

A limited partnership has three independent limited partners, A, B, and C, none of which have any relationship with the general partner. Limited partners A, B, and C hold 70%, 20%, and 10% of the limited partnership's kick-out rights through voting interests, respectively. The partnership agreement requires a simple majority vote of the kick-out rights through voting interests to remove the general partner. There are no barriers to exercising the kick-out rights, and the limited partners do not have any substantive participating rights. Assume the limited partnership would not be a VIE under any other characteristic.

Is the limited partnership a VIE under Characteristic 2?

Analysis

No. In this example, the partnership agreement requires a simple majority vote of the limited partnership's kick-out rights through voting interests to remove the general partner and the general partner cannot vote. As the limited partners are not related to the general partner, the kick-out right provided by the partnership agreement is consistent with the kick-out requirements in ASC 810-10-15-14(b)(1)(ii). Limited partner A with 70% of the kick-out rights through voting interest is able to unilaterally remove the general partner. Therefore, the limited partners would not lack the power to direct the significant activities of the limited partnership. Since none of the other VIE criteria are met, the limited partnership would be considered a voting interest entity.

Under the voting interest model, limited partner A has a controlling financial interest and would consolidate the entity as it can unilaterally exercise its kick-out rights through voting interests to remove the general partner and none of the other limited partners have any substantive participating rights.

EXAMPLE CG 4-14**Kick-out rights exercisable by the limited partners**

A limited partnership has three independent limited partners, none of which have any relationship with the general partner. Each limited partner holds an equal amount of the limited partnership's kick-out rights through voting interests (33.3%). The partnership agreement requires a simple majority vote of the kick-out rights through voting interests to remove the general partner. There are no barriers to exercising the kick-out rights, and the limited partners do not have any substantive participating rights. Assume the limited partnership would not be a VIE under any other characteristic.

Is the limited partnership a VIE under Characteristic 2?

Analysis

No. In this example, the partnership agreement requires a simple majority of the limited partners to remove the general partner and the general partner cannot vote. As the limited partners are not related to the general partner, the kick-out right provided by the partnership agreement is consistent with the kick-out requirements in ASC 810-10-15-14(b)(1)(ii). Therefore, the limited partners would

not lack the power to direct the significant activities of the limited partnership. Since none of the other VIE criteria are met, the limited partnership would be considered a voting interest entity.

Under the voting interest model, as no single limited partner has a simple majority of the kick-out rights through voting interests to unilaterally remove the general partner, none of the limited partners (nor the general partner) would consolidate the entity.

EXAMPLE CG 4-15

Kick-out rights exercisable by the general partner and the limited partners

A limited partnership has three independent limited partners, A, B, and C, none of which have any relationship with the general partner. Limited partners A, B, and C hold 40%, 25%, and 25% of the limited partnership's kick-out rights through voting interests. The general partner does not have any kick-out rights through its general partner interest, but holds a 10% limited partner interest which includes kick-out rights through this voting interest. The partnership agreement requires a simple majority vote of the kick-out rights through voting interests to remove the general partner. There are no barriers to exercising the kick-out rights, and the limited partners do not have any substantive participating rights. Assume the limited partnership would not be a VIE under any other characteristic.

Is the limited partnership a VIE under Characteristic 2?

Analysis

Yes. In this example, the partnership agreement requires a simple majority of the limited partners to remove the general partner. However, ASC 810-10-15-14(b)(1)(ii) requires that kick-out rights through voting interests held by the general partner and its related parties be disregarded when performing the simple majority kick-out test. Therefore, further analysis is required to determine if the kick-out right is consistent with ASC 810-10-15-14(b)(1)(ii).

In order to determine if the kick-out rights are consistent with ASC 810, the reporting entity must determine whether there is a substantive difference between the partnership's kick-out right and the simple majority requirement under ASC 810.

A simple majority under ASC 810, which would exclude the voting rights held by the general partner, would require a vote greater than 45% (50% of 90%). The smallest possible combination of limited partners that comprise a simple majority of the kick-out voting rights under ASC 810 would be limited partners B and C or 50% of the partnership's voting rights. However, under the partnership agreement, limited partners B and C would not be able to remove the general partner since their contractual kick-out rights would only be 50% and would not meet the simple majority threshold required by the partnership agreement to remove the general partner. Therefore, the limited partners would lack the power to direct the significant activities of the limited partnership and the entity would be considered a VIE. In addition, as the limited partners do not have any substantive participating rights, the general partner would consolidate the entity.

EXAMPLE CG 4-16**Kick-out rights exercisable by the general partner and the limited partners**

A limited partnership has four independent limited partners, none of which have any relationship with the general partner. The four independent limited partners A, B, C, and D each hold 20% of the limited partnership's kick-out rights through voting interests. The general partner does not have any kick-out rights through its general partner interest, but holds a 20% limited partner interest which includes kick-out rights through this voting interest. The partnership agreement requires a simple majority vote of the kick-out rights through voting interests to remove the general partner. There are no barriers to exercising the kick-out rights, and the limited partners do not have any substantive participating rights. Assume the limited partnership would not be a VIE under any other characteristic.

Is the limited partnership a VIE under Characteristic 2?

Analysis

No. In this example, the partnership agreement requires a simple majority of the limited partners to remove the general partner. However, ASC 810-10-15-14(b)(1)(ii) requires that kick-out rights through voting interests held by the general partner and its related parties be disregarded when performing the simple majority kick-out test. Therefore, further analysis is required to determine if the kick-out right is consistent with ASC 810-10-15-14(b)(1)(ii).

In order to determine if the kick-out rights are consistent with ASC 810, the reporting entity must determine whether there is a substantive difference between the partnership's kick-out right and the simple majority requirement under ASC 810.

The smallest possible combination of limited partners that comprise a simple majority of the kick-out rights through voting interests under ASC 810 would be any three of the independent limited partners or 75% (60%/80%). Any three of the independent limited partners would also be able to remove the general partner since their kick-out rights through voting interests would be 60% (60%/100%) and would meet the simple majority threshold required by the partnership agreement to remove the general partner. Therefore, the limited partners would not lack the power to direct the significant activities of the limited partnership. Since none of the other VIE criteria are met, the limited partnership would be considered a voting interest entity.

Under the voting interest model, as no single limited partner has a simple majority of the kick-out rights through voting interests to unilaterally remove the general partner, none of the limited partners (nor the general partner) would consolidate the entity.

EXAMPLE CG 4-17**Supermajority kick-out rights exercisable by a single limited partner**

A limited partnership has three independent limited partners, A, B, and C, none of which have any relationship with the general partner. Limited partners A, B, and C hold 70%, 20%, and 10% of the limited partnership's kick-out rights through voting interests, respectively. The partnership agreement requires a vote of at least 67% of the kick-out rights held by the limited partners through voting interests to remove the general partner. There are no barriers to exercising the kick-out rights, and the limited partners do not have any substantive participating rights. Assume the limited partnership would not be a VIE under any other characteristic.

Is the limited partnership a VIE under Characteristic 2?

Analysis

No. In this example, the partnership agreement requires a supermajority vote of the limited partnership's kick-out rights through voting interests to remove the general partner. Therefore, further analysis is required to determine if the kick-out right is consistent with ASC 810-10-15-14(b)(1)(ii).

In order to determine if the kick-out rights are consistent with ASC 810, the reporting entity must determine whether there is a substantive difference between the partnership's kick-out right and the simple majority requirement under ASC 810.

Limited partner A would be able to remove the general partner since its kick-out rights through voting interests would be 70% and would exceed the threshold required by the partnership agreement of 67% to remove the general partner. Limited partner A's kick-out rights through voting interests would also meet the simple majority requirement under ASC 810. Therefore, the limited partners would not lack the power to direct the significant activities of the limited partnership. Since none of the other VIE criteria are met, the limited partnership would be considered a voting interest entity.

Under the voting interest model, limited partner A has a controlling financial interest and would consolidate the entity as it can unilaterally exercise its kick-out rights through voting interests to remove the general partner and none of the other limited partners have any substantive participating rights.

See ASC 810-10-55-4N to ASC 810-10-55-4W for additional illustrative implementation guidance for assessing kick-out rights for limited partnerships.

4.4.5.3 Participating rights

Substantive participating rights held by limited partners would also demonstrate that the partnership is a voting interest entity under Characteristic 2. A participating right allows the holder to veto or block a significant decision of an entity being evaluated for consolidation.

Unlike a kick-out right, a participating right does not convey power since it does not allow the holder to *initiate* the action or decision. A participating right allows the holder to *prevent* another party from exercising power over a decision or significant activity of the potential VIE.

Determining whether a participating right is substantive requires consideration of the decisions or activities that the holder of the participating right may block (veto). The threshold, or level of decisions or activities the holder must be able to block (veto) to demonstrate that a participating right is substantive varies depending upon the nature of the entity and the consolidation model being applied.

Participating rights over a limited partnership or similar entity are evaluated differently than other entities when determining whether Characteristic 2 is present. The threshold established by the voting interest model to assess whether a participating right is substantive should be applied when determining whether a limited partnership or similar entity is a VIE under Characteristic 2. ASC 810-10-25-5 defines a participating right as the right to block or participate in significant financial and operating decisions that are made in the ordinary course of business. As such, a limited partnership or

similar entity would not be a VIE under Characteristic 2 if the limited partners have the ability to block at least one significant operating or financial decision made in the ordinary course of business.

4.4.5.4 *Evaluating the impact of liquidation rights*

A partnership's governing documents often provide its limited partners with the right to liquidate the partnership without cause. Kick-out rights include both removal *and* liquidation rights. Liquidation rights provide the holder with the ability to effectively remove the entity's decision maker by dissolving the entity.

The outcome for the decision maker will be the same regardless of whether it is kicked out or the entity is liquidated (i.e., it will be stripped of its ability to exercise power).

If the group of at-risk equity investors has the ability to liquidate a partnership, that liquidation right must be substantive to demonstrate that Characteristic 2 is not present. Specifically, reporting entities should consider whether the limited partners would be subject to financial or operational barriers that would act as a disincentive to exercising the liquidation right. In addition, the reporting entity should consider whether a reasonable mechanism exists to allow the unrelated limited partners to exercise the right.

Liquidation rights would not be substantive when operational or financial barriers exist that would disincentivize the unrelated limited partners from exercising the right. A liquidation right would not be substantive if the unrelated limited partners lack an explicit mechanism to exercise the liquidation right, for example, when they are unable to obtain the identities of the other limited partners to convene a general meeting and/or when they lack the ability to call a general meeting.

4.4.5.5 *Evaluating the impact of redemption rights*

With very limited exceptions, redemption rights held by the limited partners of a partnership should not be considered equivalent to kick-out or participation rights. A redemption right differs from a kick-out or liquidation right legally and economically.

Legally, an investor's redemption of its interest does not provide the holder with the ability to remove the decision maker. Rather, it provides the investor with the ability to liquidate its investment without impacting the decision maker's ability to make ongoing decisions. In other words, a redemption right is simply a liquidity feature inherent in the investor's equity interest as opposed to a right to remove the decision maker.

There may be instances when a limited partnership or similar entity has a single investor who has the right to redeem its interest at any time. We believe the facts and circumstances of those situations should be carefully considered to determine whether the single investor's ability to redeem its interest should be viewed as a substantive liquidation right. If the redemption of the investor's interest would result in a liquidation of the entity, or the termination of all substantive operating activity within the entity, then that redemption right may be no different than a liquidation right.

Example CG 4-18 illustrates the determination of whether a redemption right represents an in-substance liquidation right.

EXAMPLE CG 4-18

Determining whether a redemption right represents an in-substance liquidation right

Company A established a limited liability company (LLC Corp) for the purpose of raising third-party capital to invest in liquid publicly listed securities. LLC Corp's objective is to acquire and hold undervalued securities and then to dispose of them on an opportunistic basis.

A single investor, Company B, which is unrelated to Company A, holds 99.9% of LLC Corp's member interests. Company B acquired its 99.9% member interest in exchange for cash. Company A, LLC Corp's managing member, holds the remaining 0.1% equity interest, which it acquired in exchange for a nominal cash contribution. LLC Corp is similar to a limited partnership from both a governance and ownership perspective (i.e., not governed by a board of directors and its members have separate capital accounts).

Company B has the ability to redeem its interest in LLC Corp at any time. If Company B redeems its interest and LLC Corp has no other members, Company A is required to wind down LLC Corp's operations. Company B is not otherwise able to liquidate LLC Corp or replace Company A as LLC Corp's managing member.

Does Company B's ability to redeem its interest represent an in-substance liquidation right?

Analysis

Yes. Since Company B is the sole member of LLC Corp, and LLC Corp is required to wind down its operations if Company B exercises its redemption right, this is no different than Company B having the ability to unilaterally liquidate LLC Corp. Because Company B has the ability to strip Company A of its decision making rights as managing member of LLC Corp upon exercising its redemption right, Characteristic 2 is not present and LLC Corp is not a VIE under ASC 810-10-15-14(b)(1)(i).

4.4.5.6 ***Outsourced decision making arrangements – LP's***

In some cases, determining whether power is held by the general partner or another party can be challenging. This is particularly true when there are separate management contracts held by the general partner's related parties. In such instances, the following questions should be considered:

- **What is the ownership structure of/relationship between the general partner (managing member) and the related party that holds the investment management agreement (i.e., are the entities commonly controlled)?** In the event that the general partner and the related party are under common control, and the substance of the arrangement is that the investment decisions are effectively made by the general partner (due to the common control relationship of the related party and the general partner), it could be inferred that the significant decision-making rights reside with the general partner.
- **Does the general partner have the legal right to sell/transfer its decision-making rights to an unrelated entity?** If the general partner transfers its general partnership interest to a third party, the right to appoint the manager automatically also transfers to the third party. This would be indicative of the decision-making rights residing in the GP interest.

- **Does the general partner have the legal right to terminate the investment management agreement?** If the general partner has the legal right to terminate the management agreement at any time and at its sole discretion, the general partner has most likely retained the substantive decision-making rights over the limited partnership. All factors, including penalties associated with early termination, should be considered to determine whether or not the termination right is substantive.

If, after considering the factors described above, it is determined that the outsourced decision maker has substantive decision-making rights (as opposed to the general partner), the limited partners must have substantive kick-out or participating rights over the outsourced decision maker. Otherwise, Characteristic 2 will be present and the limited partnership will be a VIE.

4.5 **VIE Characteristic 3: equity with nonsubstantive voting rights**

ASC 810-10-15-14(c)

The equity investors as a group also are considered to lack characteristic (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.

An entity is considered a VIE under Characteristic 3 if both of the following criteria are met:

- **Criterion 1:** The voting rights of some investors are not proportional to their economic interest (i.e., obligations to absorb the entity's expected losses and rights to expected residual returns).
- **Criterion 2:** Substantially all of the entity's activities either involve or are conducted on behalf of the investor(s) with disproportionately fewer voting rights.

This characteristic is intended to identify entities that are structured so that an entity can avoid consolidation under the voting interest model by providing nonsubstantive voting rights to another party. In essence, this provision is meant to catch potential abuses of the voting interest model (e.g., to

avoid consolidation) where the voting rights held by the entity's investors are not useful in identifying which party has a controlling financial interest in the entity being evaluated for consolidation.

4.5.1 **Criterion 1: disproportionate voting and economics**

Under Criterion 1, each equity investor should be evaluated individually to determine whether its obligation to absorb the entity's expected losses and/or receive the entity's expected residual returns are in proportion to that investor's voting rights. Characteristic 3 is different from the other five characteristics of a VIE in that all variable interests held by the holders of equity at risk must be considered, and not just the voting rights and economics related to each investor's equity investment.

Related parties should not be considered in the evaluation of Criterion 1, but should be considered in an evaluation of Criterion 2 (discussed below).

When evaluating whether Criterion 1 has been met, we believe an investor's voting rights and economics are not required to be identical, but should generally be approximately the same, to be considered proportionate. Judgment should be applied based on the facts and circumstances.

Question CG 4-5

If a reporting entity's economic interest in an entity is greater than its relative voting interest, is Criterion 1 met?

PwC response

The disproportionate voting and economic interest criterion was included to identify entities designed with nonsubstantive voting rights. It is the intent of GAAP to subject those entities to the "power" and "economics" model established in ASC 810-10. In situations where the interests are disproportionate, it should not be automatically assumed that the criterion is met. Additional analysis should be performed to determine whether the entity's voting rights would be substantively different if its relative voting rights mirrored its economic interest.

For example, if an investor held a 25% economic interest in an entity but was limited to exercising 15% of its relative voting rights, a reporting entity should consider whether that investor's ability to influence or participate in the entity's operating or financial decisions would be substantively different if the investor held 25% of the entity's relative voting rights. If the investor's ability to influence or participate in the entity's operating or financial decisions would not be substantively different if it held 25% of the entity's relative voting interests, then it should not be assumed that the investor's voting and economic interests are disproportionate (i.e., that Criterion 1 is met).

When an investor's economic and voting interests straddle 50% (i.e., 48% voting rights and 52% economics), its voting and economic interests should not ordinarily be considered proportional. Generally, an investor's ability to exercise voting rights over an entity would be substantively different when its voting interest crosses the 50% threshold.

In practice, joint ventures and partnerships frequently meet this criterion as the equity investors typically have other variable interests in the entity that create economics that are disproportionate to their voting rights.

Based on a literal read of the guidance, evaluation of Criterion 1 would require a comparison of each participant's variable interests to their voting interest, which would necessitate the determination of all expected losses and expected residual returns for the entity and for each investor. However, in some circumstances, detailed analyses may not be necessary. For example, if one party clearly has an economic participation of 60% or greater, but only has a noncontrolling 50% voting interest, Criterion 1 would be met (i.e., the voting interests and economic interests would be disproportionate). Criterion 2 would then need to be evaluated to determine if the entity should be considered a VIE.

Conversely, if one party has 50% of the vote and 40% of the equity, but also has a variable interest via a long-term purchase contract, a detailed calculation may be required to determine if the equity investor's incremental economic exposure through the purchase contract causes the equity investor to be exposed to greater than 50% of the entity's expected losses and residual returns.

The determination of the level of voting rights may require judgment, since, in many cases, voting percentages are not defined by the underlying agreements.

Question CG 4-6

If a partnership with three investors operates in a manner that requires all three investors to agree to all significant operating decisions, what level of voting rights should the partners be considered to hold if their relative ownership interests are not equal?

PwC response

Even though the partners' legal ownership percentages may vary, we believe the entity is under joint control and each partner would have 33.3% of the partnership's voting interests.

In this scenario, when assessing whether Criterion 1 of Characteristic 3 has been met, the analysis should focus on whether the governance of the entity would be substantively different if voting rights were exactly equal to the investor's economic interest. If the governance of the entity would be substantively different, then Criterion 1 of Characteristic 3 would be met.

To further understand the application of Criterion 1, consider Example CG 4-19, Example CG 4-20, and Example CG 4-21.

EXAMPLE CG 4-19

Determining whether a majority investor's interest is disproportionate

Company A holds a 65% equity interest in Entity 1 and Company B holds the remaining 35% equity interest. Company A and Company B share in Entity 1's profits and losses in proportion to their relative equity investment. Entity 1's governing documents include specific provisions providing Company B with approval rights over the substantive operating decisions of Entity 1 (i.e., joint control).

Is Criterion 1 met?

Analysis

Yes. Entity 1's governing documents provide Company A with a 50% vote over key operating decisions. If Company A's voting rights equaled its 65% economic interest, its right to govern Entity 1 would be substantively different. Consequently, Criterion 1 would be met. If Criterion 2 is also met (i.e., substantially all of the entity's activities either involve or are conducted on behalf of Company A and its related parties), Characteristic 3 would be present and Entity 1 would be considered a VIE.

EXAMPLE CG 4-20**Determining whether a majority investor's interest is disproportionate**

Company A is an equity investor in Corporation X, holding 55% of Corporation X's voting interests. Through its 55% voting interest, Company A is able to control Corporation X. Company A is exposed to 60% of Corporation X's profits and losses.

Is Criterion 1 met?

Analysis

No. Although Company A's voting rights (55%) and exposure to Corporation X's economics (60%) are not exactly equal, Company A's voting and economic interests would be considered proportional since control resides with Company A at either the 55% or 60% level.

EXAMPLE CG 4-21**Determining whether other interests held by a 50% equity investor cause disproportionality**

Company A and Company B each contributed \$20 million in cash for 50% of Corporation X's common stock. In addition, Company A loaned \$50 million to Corporation X in return for a note receivable. Company A therefore has two variable interests in Corporation X: (1) an equity investment and (2) a note receivable from Corporation X.

Is Criterion 1 met?

Analysis

Most likely. While it is likely that the note receivable absorbs little variability in the change in Corporation X's net assets given its seniority in Corporation X's capital structure (i.e., it exposes Company A to little credit risk), it would be required to absorb very little variability to increase Company A's total economic exposure above 50%.

4.5.2 Criterion 2: evaluating the “substantially all” concept

For Characteristic 3 to be present, Criterion 2 must also be met. Meeting this criterion requires substantially all of an entity's activities to involve or to be conducted on behalf of the investor (and its related parties) with disproportionately few voting rights. We believe an evaluation of whether this criterion has been fulfilled should be consistent with the evaluation performed under the business scope exception given the consistency of the “substantially all” terminology used (refer to CG 2.3.4 for discussion of the business scope exception).

As a general rule, we believe this assessment should be primarily qualitative.

Figure CG 4-3 lists indicators to consider in our evaluation (this is the same list of indicators included in CG 2.3.4):

Figure CG 4-3

Indicators of whether the substantially all criterion has been met

Strong indicators ¹	Other indicators ¹
<ul style="list-style-type: none"> □ The reporting entity sold assets to the entity in an effort to remove underperforming assets from the reporting entity's balance sheet. 	<ul style="list-style-type: none"> □ The reporting entity sold assets to the entity.
<ul style="list-style-type: none"> □ The entity's major activities include selling substantially all of its products to the reporting entity under long-term contracts. 	<ul style="list-style-type: none"> □ The entity's major activities include selling a majority of its products to the reporting entity, and these arrangements are expected to continue either because of long-term contracts or for other reasons.
<ul style="list-style-type: none"> □ The entity's major activities include purchasing substantially all of its purchased products from the reporting entity. 	<ul style="list-style-type: none"> □ The entity's major activities include purchasing a majority of its purchased products from the reporting entity.
<ul style="list-style-type: none"> □ The reporting entity holds a non-reciprocal, fixed-price or "in-the-money" call option on the other investors' equity investments, and/or the other investors have a fixed-price or "in-the-money" put option whereby they can put their investments to the reporting entity. 	<ul style="list-style-type: none"> □ The reporting entity holds a non-reciprocal (or fair value) call option on the other investors' equity investments, and/or the other investors have a similarly priced, non-reciprocal put option.
<ul style="list-style-type: none"> □ The reporting entity is obligated to provide substantially all of any additional capital contributions that may be necessary to cover operating shortfalls. 	<ul style="list-style-type: none"> □ The reporting entity is obligated to provide a majority of any additional capital contributions that may be necessary to cover operating shortfalls.
<ul style="list-style-type: none"> □ The entity performs research and development activities, and the reporting entity has an economic interest (e.g., through a purchase option) in the results of the research that constitutes substantially all of the entity's activities. 	<ul style="list-style-type: none"> □ The entity performs research and development activities, and the reporting entity is in a business that could capitalize on the results of the research that constitutes a majority of the entity's activities.
<ul style="list-style-type: none"> □ The reporting entity has outsourced operations to the entity, constituting substantially all of the entity's activities. 	<ul style="list-style-type: none"> □ The reporting entity has outsourced to the entity operations that constitute a majority of the entity's activities.
<ul style="list-style-type: none"> □ Substantially all of the entity's assets are leased to the reporting entity. 	<ul style="list-style-type: none"> □ A majority of the entity's assets are leased to the reporting entity.

Strong indicators¹	Other indicators¹
<ul style="list-style-type: none"> □ The principal activity of the entity is to provide financing (e.g., loans or leases) to the reporting entity’s customers. 	<ul style="list-style-type: none"> □ A majority of the entity’s activities involve providing financing (e.g., loans or leases) to the reporting entity’s customers.
<ul style="list-style-type: none"> □ The principal purpose of the entity is to conduct a business that is uniquely complementary to a significant business operation of the reporting entity and is not similar to activities of other participants in the entity. 	<ul style="list-style-type: none"> □ The principal purpose of the entity is to conduct a business that is more closely related to a significant business operation of the reporting entity and only broadly similar to activities of one or more of the other participants in the entity.
<ul style="list-style-type: none"> □ The economics (e.g., capital at risk, participation in profits, etc.) are heavily skewed (e.g., close to 90% or greater) toward the reporting entity. 	<ul style="list-style-type: none"> □ The economics (e.g., capital at risk, participation in profits, etc.) are weighted (e.g., greater than 60%) toward the reporting entity.

¹With respect to evaluating these indicators, the term “reporting entity” includes the reporting entity’s related parties (as defined in ASC 810-10-25-43).

In contrast to Criterion 1, the investor must combine interests held by its related parties with its own interests when assessing Criterion 2 (refer to CG 5.4 for a detailed discussion of related parties).

If several of the “Other indicators” are present, the reporting entity should consider whether or not the requirements of Criterion 2 have been met. There are no broad rules of thumb that can be used to shortcut the evaluation required under Criterion 2. Instead, reporting entities will need to evaluate the relevant facts and circumstances surrounding each individual situation. Absent mitigating factors (i.e., indicators that point to a different conclusion), we believe that the presence of a single item from the “Strong indicators” column may be sufficient to support a conclusion that substantially all of the activities of the entity either involve or are conducted on behalf of the reporting entity.

At other times, multiple strong indicators may need to be present to reach the same conclusion. There are no “bright lines” and this assessment requires judgment and will be based on facts and circumstances. Some have suggested that the phrase “substantially all” should be interpreted to mean that 90% or more of the economics of the entity relate or accrue to the benefit of a particular party. We believe that such a quantitative measure is only one of many factors that should be considered in evaluating this criterion. However, we recognize that there may be circumstances where the economics of the arrangement are so skewed in the direction of one reporting entity that a quantitative analysis may override other considerations.

4.6 VIE Characteristic 4: lack of obligation to absorb losses

Non-equity interests (e.g., debt) issued by voting entities generally do not absorb the entity’s losses until its equity interests are fully depleted. The VIE model indicates that an entity is considered a VIE if, as a group, the holders of the equity investment at risk lack the following:

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

This assessment should focus on whether the entity's equity investors are exposed to its expected losses on a "first-dollar loss" basis.

Excerpt from ASC 810-10-15-14(b)

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.

An evaluation of whether Characteristic 4 is present should focus on the equity interests as opposed to the identity of the equity investors. In most cases, a reporting entity should be able to make this assessment qualitatively.

When other variable interests that do not qualify as equity at risk absorb the entity's expected losses before its equity at risk is fully depleted, we do not believe the entity should automatically be presumed to be a VIE.

We believe Characteristic 4 may be present if a potential VIE is designed such that its equity interests do not fully absorb the entity's expected losses on a first-dollar loss basis. If other variable interests begin sharing in the entity's expected losses before the equity investment at risk is fully depleted, and that sharing is part of the entity's design, then the entity may be a VIE. An entity may also be a VIE under Characteristic 4 if it issued equity with puttable characteristics that are embedded in the terms of the interest.

4.6.1 *Impact of implicit variable interests*

ASC 810-10-25-48 through ASC 810-10-25-54 address if and when a reporting entity holds an implicit variable interest in a potential VIE. The existence of an implied variable interest may affect the determination of whether an entity should be considered a VIE, particularly with respect to Characteristic 4. For example, if a variable interest holder implicitly guaranteed the value of a potential VIE's sole asset, then the entity would be considered a VIE under Characteristic 4. In that situation, the implied guarantee protects the holders of equity at risk from suffering the entity's expected losses before the equity at risk is fully depleted.

See CG 3.6 for a further discussion of implicit variable interests.

4.6.2 *Examples of how to evaluate an entity under Characteristic 4*

The following examples illustrate how to assess whether the entity being evaluated for consolidation is considered a VIE under Characteristic 4.

Disproportionate loss sharing arrangements

Disproportionate sharing of expected losses among the holders of equity at-risk do not cause an entity to be a VIE under Characteristic 4. The assessment of whether Characteristic 4 is present should be based on an analysis of the holders of equity at risk, *as a group*, as opposed to individual at risk equity investors.

Disproportionate sharing arrangements among individual equity investors do not shield the holders of equity investment at risk, *as a group*, from absorbing the entity's expected losses. Such arrangements change the manner in which the individual holders of equity at risk absorb the entity's expected losses. Although holders of equity at risk may individually be protected from the entity's expected losses to some extent, the *group* would continue to be exposed the entity's expected losses on a first-dollar basis. This may also indicate that Characteristic 3 is present as individual investors may have disproportionate economic interests and voting rights. Refer to CG 4.5 for further details on Characteristic 3.

Debt guarantees

A debt guarantee generally would be considered a variable interest under the VIE model because it may absorb some portion of the entity's expected losses. As a result, a reporting entity must determine whether the guarantee was incorporated into the design of the entity to protect the entity's equity investors from absorbing the potential VIE's expected losses on a first-dollar loss basis.

Debt guarantees are generally not called upon until the equity investment at risk is fully depleted. Therefore, debt guarantees typically do not cause the entity to be a VIE under Characteristic 4. Reporting entities should, however, carefully consider whether the existence of a debt guarantee causes an entity to be a VIE under Characteristic 1. Refer to CG 4.3 for further discussion.

Residual value guarantees provided by a lessee

In many leasing transactions, a lessor may require the lessee to provide a residual value guarantee on the asset that is subject to the lease arrangement. The residual value guarantee is intended to protect the equity investors of the lessor from any decline in the fair value of the leased asset. In other words, the residual value guarantee will absorb losses before the equity at risk is fully depleted.

To determine whether a lessee provided residual value guarantee causes an entity to be a VIE under Characteristic 4, a reporting entity should first consider whether the residual value guarantee represents a variable interest in the lessor entity. If the residual value guarantee is a variable interest in the lessor entity, and that variable interest absorbs the lessor entity's expected losses before its equity at risk is fully depleted, Characteristic 4 would be present and the lessor entity would be a VIE.

When a lessee provides a residual value guarantees on specified assets that represent less than 50% of the fair value of the potential VIE's total assets, the residual value guarantee would not be considered a variable interest in the entity (the residual value guarantee would represent a variable interest in specified assets). If the residual value guarantee does not represent a variable interest in the entity, Characteristic 4 would not be present and the lessor entity would not be a VIE.

Conversely, a lessee provided residual value guarantee would be considered a variable interest when the guarantee is provided on the lessor's entity's sole asset, or specified assets that represent greater

than 50% of the fair value of the lessor's entity's total assets. If the residual value guarantee is a variable interest, then the lessor entity would be a VIE under Characteristic 4.

Refer to CG 3.7 for further discussion around the distinction between variable interests in specified assets versus variable interests in an entity.

Residual value guarantees on an entity's assets provided by an equity investor

An equity investor may provide a residual value guarantee on an asset that the investee (a legal entity) holds. If the fair value of the asset subject to the residual value guarantee represents greater than 50% of the fair value of the entity's total assets, the residual value guarantee would be a variable interest in the entity and the arrangement may cause the entity to be a VIE under Characteristic 4. Although the investor may have the economic obligation to absorb the entity's losses on a first-dollar basis, the obligation stemming from the residual value guarantee is not embedded in the terms of the investor's equity interest and would begin absorbing the entity's expected losses before the equity at risk is fully depleted.

Insurance contracts

Entities routinely enter into insurance arrangements to insulate themselves from risk of loss arising from unforeseen events (e.g., fires, storms) or unplanned interruptions of their business operations. Examples of such arrangements include property and casualty and business interruption insurance. Applying Characteristic 4 to these contracts on a literal basis would cause many traditional companies to be considered VIEs.

Although normal and customary insurance arrangements protect an entity's equity investors from risk of loss, we do not believe Characteristic 4 is intended to capture such situations. If these normal and customary insurance arrangements protect the equity investors from risk of loss stemming from the occurrence of unusual events, as opposed to losses that occur in the normal course of business (i.e., the predominant risks the entity was designed to create and pass along to its variable interest holders), we do not believe such arrangements would cause an entity to be a VIE under Characteristic 4. The group of at risk equity investors must, however, be exposed to risk of loss arising in the normal course of business to demonstrate that an entity is not a VIE under Characteristic 4.

Total-return swaps

Total-return swaps are an example of a variable interest that generally causes an entity to be a VIE under Characteristic 4. If a total-return swap protects the group of at risk equity investors from an entity's expected losses, then Characteristic 4 would be present and the entity would be considered a VIE.

Example CG 4-22 illustrates the assessment of the impact of a total-return swap under Characteristic 4.

EXAMPLE CG 4-22

Assessing the impact of a total-return swap under Characteristic 4

Company A (1) issues debt of \$250 and common stock of \$50, and (2) acquires a bond with a fair value of \$300. Assume that Company A enters into a total-return swap with Bank B. The terms of the

arrangement provide that Bank B will pay 85% of the total return of the bond in exchange for a LIBOR-based return. That is, if the bond's value declines by one dollar, the Bank B will pay the entity 85%.

Does the total-return swap cause Company A to be a VIE under Characteristic 4?

Analysis

Yes. The equity interests are protected from 85% of the asset's losses. As a result, the entity would be deemed a VIE under this characteristic.

Cost-plus sales contracts

Sometimes manufacturers or service providers, acting in the capacity of a vendor, sell goods or services at a price that allows the vendor to recoup some or all of its operating costs plus a fixed margin. These arrangements are commonly referred to as "cost-plus" sales contracts.

Cost-plus sales contracts may cause the entity selling the goods or services (the vendor) to be a VIE under Characteristic 4 if the arrangement protects the vendor's equity investors from absorbing the entity's expected losses. The most straightforward example of where a cost-plus sales contract protects a vendor's equity investors from suffering its expected losses is when the vendor sells all of its goods or services to a single customer at a price that varies based on its operating costs plus a fixed or variable mark-up. In that situation, the vendor's customer would bear all of the entity's operating risk through its variable pricing structure, thereby insulating the vendor's equity investors from risk of loss.

Example CG 4-23 illustrates the assessment of the impact of a cost-plus sales contract under Characteristic 4.

EXAMPLE CG 4-23

Assessing the impact of a cost-plus sales contract under Characteristic 4

Company A and Company B formed Corporation X, each contributing \$1,000 of cash in exchange for a 50% equity interest at formation. Corporation X also executed a sales agreement with Company A at formation, the terms of which require Company A to purchase 90% of the goods Corporation X manufactures. The price paid by Company A is equal to the costs to produce the goods, plus a 7% markup.

Does the supply agreement cause Corporation X to be a VIE under Characteristic 4?

Analysis

Yes. The sales contract, which is not part of Corporation X's equity at risk, protects its equity investors from substantially all of its operating risks. Although Company A and Company B are exposed to 10% of Corporation X's operating risks, this is not significant enough to overcome the level of protection provided based on the design of the entity. As such, Characteristic 4 would be present and Corporation X would be a VIE.

Some element of all commercial pricing arrangements is based on the vendor's operating costs plus a profit margin. Assessing whether such arrangements indicate the presence of Characteristic 4 should be based on the relevant facts and circumstances. This analysis becomes more complicated when the vendor sells goods or services to different customers or when it renegotiates pricing with customers on a recurring basis.

We believe cost-plus sales arrangements with pricing schemes that reset periodically may indicate that the vendor's equity investors are insulated from all operating risk, thereby causing the entity to be a VIE under Characteristic 4. Determining whether Characteristic 4 is present would ultimately require consideration of the level of protection the vendor's at risk equity investors are provided through the arrangement.

Purchased fixed-price put options on an entity's assets

An entity may purchase protection against a decline in the fair value of one or more assets it holds. If this downside protection is obtained through a fixed-price put option on the entity's assets, a reporting entity should determine whether the put option represents a variable interest in the entity or a variable interest in specified assets. If the put option represents a variable interest in specified assets, then the purchased put option does not protect the group of at-risk equity investors from the entity's expected losses. Consequently, the entity would not be a VIE under Characteristic 4.

Conversely, a fixed-price put option that is a variable interest in the entity as a whole may demonstrate that Characteristic 4 is present and the entity would be a VIE. A purchased fixed-price put option on an entity's assets represents a variable interest in the entity as a whole when the puttable assets underlying the option represent greater than 50% of the entity's assets on a fair value basis. If the put option is a variable interest in the entity and begins to share in the entity's expected losses before the equity investment at risk is fully depleted, Characteristic 4 would be present and the entity would be a VIE.

Purchased fixed-price put options on an entity's equity interests

A purchased fixed-price put option on an entity's equity interest may cause either the equity interest to not qualify as equity at risk or the entity to be a VIE under Characteristic 4. If the put feature is embedded in the terms of the equity interest (e.g., the entity issues puttable shares to the equity investor), the equity interest will likely not be equity at risk since the equity interest will not participate in losses of the entity. If the put feature is not embedded in the terms of the equity interest (e.g., the equity investor buys a put option from one of the other equity investors of the entity) the equity interest would be equity at risk, assuming all the other equity at risk conditions are met. However, if the terms of the put are substantive (e.g., in-the-money put with a reasonable term), the put feature would cause the equity interest to be protected from losses and therefore the entity would be a VIE under Characteristic 4.

In contrast, an equity investor may purchase a put option from a third party to insulate itself from a degradation in the fair value of the potential VIE's equity value. If that downside protection is obtained through a freestanding contract that was entered into as part of the equity investor's normal trading activities, it is unlikely that Characteristic 4 would be present. Although the current holder of that equity interest may be protected against all or some portion of the entity's expected losses, the put would not be considered a VI because it was not acquired as part of the purpose and design of the entity. As such, we do not believe such arrangements would cause an entity to be a VIE under Characteristic 4.

Other instruments that provide protection to the equity investment at risk

Other examples of variable interests in an entity that would cause an entity to be a VIE under Characteristic 4 are:

- Guarantees of the entity's assets when that guarantee is a variable interest in the entity and not in specified assets (refer to CG 3.7 for discussion of variable interests in specified assets)
- A purchase agreement or option with a non-refundable deposit that protects the equity investment at risk from a portion of the market decline (to the extent of the deposit).

Question CG 4-7

Company A enters into a purchase and sale agreement with Company X, whereby Company A will buy from Company X land and a building, its sole assets. Company A is required to pay a significant non-refundable deposit to Company X and has the right to terminate the contract, subject to the loss of its deposit. Should Company X be considered a VIE?

PwC response

Yes. The purchase and sale agreement requires Company A (buyer) to make a significant non-refundable deposit to Company X (seller) where Company X's sole asset is the real estate subject to the agreement. The non-refundable deposit absorbs some of Company X's variability and transfers some of the risks and rewards of ownership to Company A. The protection provided to the seller through the non-refundable deposit causes Company X to be a VIE under Characteristic 4. In essence, the non-refundable deposit provides protection to Company X's at-risk equity investors from declines in value of the underlying asset on a first-dollar loss basis before the equity investment at risk is fully depleted. Once the non-refundable deposit is depleted, the at-risk equity investors would begin participating in further declines in the fair value of the entity's asset.

4.7 *VIE Characteristic 5: lack of right to receive residual returns*

Characteristic 5 is based on the principle that traditional voting entities issue equity interests that allow the holder to receive the entity's residual profits. The VIE model indicates that an entity is also considered a VIE if, as a group, the holders of the equity investment at risk lack the following:

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

The intent of Characteristic 5 is also illustrated in the excerpt below:

Excerpt from ASC 810-10-15-14(b)

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.

An evaluation of whether Characteristic 5 is present should focus on the equity interests as opposed to the identity of the equity investors. In most cases, a reporting entity should be able to make this assessment qualitatively.

If an entity is designed to issue equity interests that do not allow the holder to participate in the entity's expected residual returns (i.e., the equity interests have embedded fixed-price callable features), we believe the entity may be a VIE. Additionally, when other variable interests that do not qualify as equity at risk share in, or fully absorb an entity's expected residual returns, the entity that issued those equity interests may be a VIE.

In other instances, a variable interest that does not qualify as equity at risk may share in the entity's expected residual returns. For example, an entity may enter into arrangements with a service provider that include a performance-based compensatory element. If that other variable interest was not entered into as part of the entity's purpose and design, but was entered into as part of the entity's normal course of business (i.e., normal course sharing arrangements), the entity would not be a VIE. In making this evaluation, we believe that variable interests that share in a large portion (e.g., 30%) of an entity's expected residual returns would not likely be a normal course of business feature.

4.7.1 Examples of how to evaluate an entity under Characteristic 5

The following sections illustrate how certain contractual arrangements impact the assessment of whether the entity being evaluated for consolidation is considered a VIE under Characteristic 5.

4.7.1.1 Disproportionate sharing of returns among equity investors

Disproportionate sharing of expected residual returns among the holders of equity at risk does not cause an entity to be considered a VIE under Characteristic 5. Characteristic 5 focuses on whether the group of at-risk equity investors has the rights to the entity's expected residual returns, as opposed to the manner in which the expected returns are shared among the group.

Disproportionate sharing arrangements change the manner in which the individual holders of equity at risk receive the entity's expected returns. Although individual holders of equity at risk may individually be prohibited from receiving the entity's expected residual returns to some extent, the group would continue to fully receive the entity's expected returns.

4.7.1.2 Written fixed-price call option on the entity's assets

Written call options on an entity's assets that represent less than a majority of the entity's total assets on a fair value basis would not be considered a variable interest in the entity as a whole (from the holder's perspective). If the written call option does not represent a variable interest in the entity, it would not cap the ability of the holders of equity at risk, as a group, from receiving the potential VIE's expected residual returns.

If the assets underlying the written call option represent more than 50% of the entity's total assets on a fair value basis, then the written call option may cap the investor's ability to receive the entity's expected residual returns. Determining whether the written call option functions as a cap depends on the specific facts and circumstances. Relevant factors will include whether the option's strike price is fixed, formula-based, or at fair value. A call option with a fair value strike price would not meet Characteristic 5, whereas a call option that is formula-based may meet Characteristic 5.

4.7.1.3 Written fixed-price call options on the entity's equity interests

Written fixed-price call options on an entity's equity interest would allow the holder of the call to participate in the entity's expected residual returns. If the amount of the expected residual returns absorbed by the call was large in relation to the expected residual returns absorbed by the entity's total equity, the entity would be a VIE.

Example CG 4-24 illustrates the assessment of the impact of a written call on an equity interest.

EXAMPLE CG 4-24

Assessing the impact of a written call on an equity interest

Company A and Company B formed Corporation X. At formation, Company A received a 75% equity interest in exchange for a \$750 cash contribution. Company B received a 25% equity interest in exchange for a \$250 cash contribution. All of Corporation X's profits and losses are shared among Company A and Company B in accordance with the relative ownership percentages.

Subsequent to the formation of Corporation X, Company A wrote a call option to Company C allowing Company C to purchase Company A's 75% equity interest for \$1,000 at any time for a period of two years. The call option was entered into as a part of the redesign of Corporation X and is a freestanding financial instrument.

Does Company C's call option on Company A's 75% equity investment cause Corporation X to be a VIE under Characteristic 5?

Analysis

Maybe. While the call provides Company C with rights to a portion of Company X's expected residual returns, the extent of those rights would need to be assessed. The call is written out of the money and has a limited term of two years. These features together with the relevant facts around Company X's operations may support a conclusion that the amount of expected residual returns absorbed by the call may not be substantial (in which case the entity would not be a VIE).

In some cases, the potential VIE may write a call option on its own equity interests. The call option may be freestanding and issued as compensation, or embedded in another financial instrument that was issued as part of a financing transaction. Examples include employee stock options, convertible debt, or similar interests. These variable interests should not cause the issuer of such interests to be a VIE under Characteristic 5 since the purchaser or holder of these options will become part of the group of at-risk equity investors upon exercise.

4.7.1.4 ***Outsourced decision-making fee arrangements***

An entity may enter into an arrangement with a service provider that includes a performance-based compensatory element. If a reporting entity concludes that a decision-making fee arrangement is not a variable interest in the entity as discussed in CG 3.4, we do not believe the fee arrangement would cause the entity to be a VIE. Such arrangements are consistent with other normal course sharing arrangements and do not demonstrate the existence of Characteristic 5.

If a reporting entity concludes that a service provider arrangement represents a variable interest in the entity, further analysis would be required to determine whether the reporting entity can participate in a large portion of the entity's profits. If so, we believe such arrangements may be inconsistent with normal course sharing arrangements and the entity should be considered a VIE.

The following arrangements should be carefully considered to determine whether they cause an entity to be a VIE under Characteristic 5:

- Service contracts that are indexed to the entity's performance
- Decision-making fees
- License, royalty, and other similar arrangements

We believe profits should be interpreted more broadly and not limited to items such as net income or earnings before taxes. Other performance measures (e.g., revenue, operating income, EBITDA) should also be considered. However, only those arrangements that share in a large portion of the entity's expected residual returns would cause an entity to be a VIE under Characteristic 5.

In most entities, these arrangements would not demonstrate the presence of this characteristic; however, a reporting entity should evaluate the terms of each contract and the level of the entity's returns that the counterparty is entitled to share in.

4.7.1.5 ***Other equity investments that are not considered "at risk"***

In some situations, equity may be issued in return for the promise to provide services to the entity (sometimes referred to as "sweat equity"). Because "sweat equity" does not qualify as equity at risk, a reporting entity must consider whether this equity investment caps the at-risk equity investors' ability to receive the entity's expected residual returns. We believe this would be the case when equity investments that do not qualify as equity at risk share in a large portion of the entity's expected residual returns.

Example CG 4-25 illustrates the assessment of the impact of an equity investment that is not at risk under Characteristic 5.

EXAMPLE CG 4-25

Assessing the impact of an equity investment that is not at risk under Characteristic 5

Company A and Company B formed Corporation X. At formation, Company A received a 65% equity interest in exchange for a \$1,000 cash contribution. Company B received a 35% equity interest in return for future services. All of Corporation X's cash flows are distributed to Company A and Company B in accordance with the relative ownership percentages.

Because Company B received its interest in exchange for future services, its equity investment does not qualify as equity at risk.

Does the existence of Company B's 35% equity investment cause Corporation X to be a VIE under Characteristic 5?

Analysis

Since Company B participates in the entity's expected residual returns, Characteristic 5 may be present if Company B is entitled to a large portion of returns in relation to the entity's total expected returns. If so, Characteristic 5 would be present and the entity would be considered a VIE. Generally, a 35% sharing rate would be considered large.

4.8 *When to reconsider VIE status*

If a reporting entity has a variable interest in a legal entity that does not qualify for a VIE scope exception, then it is required to determine whether that entity is a VIE at its formation date, or on the date the reporting entity first became involved with the entity.

Certain events may occur after the initial analysis that require the reporting entity to reassess whether or not an entity is, in fact, a VIE. In the VIE model, the occurrence of any of the following specific events would require the reconsideration of an entity's VIE status:

ASC 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.

A troubled debt restructuring should also trigger a reassessment of the entity's status as a VIE. In most instances, if the entity becomes a VIE upon a troubled debt restructuring, banks/lenders may conclude that they are not the primary beneficiary, although they may become subject to the VIE disclosure requirements (see FSP 18.4 for a discussion about disclosure requirements).

We believe only substantive events should trigger reconsideration of the entity's VIE status. The determination of whether an event is substantive requires judgment.

4.8.1 VIE reconsideration – reassessment of design

A reporting entity should consider the purpose and design of a potential VIE, including the risks it was designed to create and pass along to its interest holders, when determining whether the entity is a VIE. The entity's purpose and design must also be considered upon the occurrence of any event triggering a reassessment of the entity's status as a VIE. This could require the reporting entity to consider new or different risks (e.g., interest rate risk) that the entity has become exposed to since the prior analysis was performed.

The following sections discuss each of the reconsideration events described in the VIE model in further detail.

4.8.2 VIE reconsideration – losses that reduce the equity at risk

Excerpt from ASC 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 first concept discussed is the notion that operating losses in excess of an entity's expected losses that reduce its equity at risk should not trigger a reconsideration of an entity's VIE status. The rationale behind this concept focuses on the design of the entity. Incurring operating losses alone does not impact the characteristics of the equity investment at risk or the relationship between the holders of equity at risk and other variable interest holders.

If the equity at risk was deemed sufficient to finance the entity's expected activities in the initial VIE analysis, and no events that could be considered a "redesign" of the entity have occurred, then there would be no basis to conclude that the entity has become a VIE just because it has incurred operating losses.

However, if a reconsideration event does occur, the entity's VIE status will need to be re-evaluated as of that date, and a prior history of operating losses that have reduced the equity investment at risk may need to be considered as part of that analysis.

4.8.3 VIE reconsideration event – change in governing documents

ASC 810-10-35-4(a)

The legal entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity's equity investment at risk.

This reconsideration event focuses on the redesign or restructuring of an entity's governing documents or contractual arrangements among the parties involved with the entity. The clarifying phrase "that changes the characteristics or adequacy of the entity's equity investment at risk" will help determine whether a change in these documents/arrangements should trigger a reconsideration of the entity's VIE status.

Only modifications that affect the characteristics or adequacy of the entity's equity investment at risk are considered reconsideration events.

4.8.4 *Changes in characteristics of equity*

It will be easier to determine whether a modification of the governing documents or contractual arrangements affects the characteristics of the entity's equity investment at risk than to determine changes impacting the adequacy of the equity at risk.

Consider a situation where the equity investors at risk in a VIE cede certain voting rights to another variable interest holder. The reporting entity (investor) would need to consider whether the modifications in the governing documents changed the characteristics of the equity investment. In this example, the following two factors may be considered by the reporting entity to assess whether a reconsideration event has occurred:

1. Whether the rights ceded to the other variable interest holders were participating or protective rights
2. Whether the entity's VIE status would change based solely on the changed characteristics

If the modification changes the characteristics of the entity's equity investment at risk, it would be deemed a reconsideration event under the VIE model.

4.8.5 *Change in adequacy of equity at risk*

Determining whether or not a modification of the governing documents or contractual arrangements affects the adequacy of the entity's equity investment at risk can be challenging. This difficulty arises from the need to determine what caused the change in the adequacy of the equity investment at risk. Only significant modifications that directly impact the adequacy of the equity investment at risk would be considered triggering events that would require a reassessment of the entity's VIE status.

4.8.6 *VIE reconsideration event – return of equity investment*

ASC 810-10-35-4(b)

The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity.

A return of an equity investment may constitute a redesign of the entity. Since one of the five characteristics of a VIE focuses on the sufficiency of the equity investment at risk, a reduction in that amount would generally trigger a reassessment of an entity's VIE status.

The reporting entity should consider whether the return of equity at risk is significant before concluding that the reduction in equity at risk constitutes a reconsideration event. This reconsideration event is intended to focus on situations in which a return of capital has caused a voting interest entity to become a VIE.

4.8.7 **VIE reconsideration event — changes in operating activities**

ASC 810-10-35-4(c)

The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses.

This reconsideration event is also intended to focus on situations in which a voting interest entity (not previously subject to consolidation under the VIE model) may become a VIE. Specifically, it focuses on whether the unanticipated activities or newly acquired assets actually increase the entity's expected losses.

When analyzing this reconsideration event, reporting entities should consider whether there has been a redesign of the entity. During the initial VIE analysis, a reporting entity is required to assess the sufficiency of the equity at risk by evaluating the entity's current and anticipated activities and the amount of equity needed to finance those expected activities (either quantitatively or qualitatively). In a quantitative analysis, that assessment would involve calculating the potential VIE's expected losses—a calculation that would be derived from the variability or risk associated with the current and anticipated future activities of the entity. Consider Example CG 4-26.

EXAMPLE CG 4-26

Determining whether a change in an entity's activities requires a reconsideration of an entity's status as a VIE

Company A holds two financial assets: one share of stock in a "Blue Chip" utility company and one share of stock in a tech start-up company that has yet to earn a profit. At inception, Company B (one of Company A's equity investors) determined that Company A was not a VIE.

Six months later, Company A sells its share of stock in the utility company and buys an additional interest in the start-up company.

Does Company A's sale of the utility stock and acquisition of an additional interest in the start-up company require Company B to reassess Company A's status as a VIE?

Analysis

If the acquisition of this new asset was not anticipated at Company A's inception and Company A's expected losses have increased as a result of the purchase, Company B would be required to reassess Company A's VIE status.

If the reporting entity anticipated the undertaking of new activities or the acquisition of additional assets in its initial assessment under the VIE model, the occurrence of such events may not be considered a reconsideration event.

We believe assessing whether the acquisition of additional assets or the undertaking of additional activities constitutes a reconsideration event will often be driven by specific facts and circumstances, and will depend heavily on the entity's current business activities (e.g., an operating joint venture versus an SPE that holds financial assets). The threshold for concluding that a reconsideration event has occurred will likely be higher for an operating joint venture than an SPE.

In making the assessment, the reporting entity should consider whether the acquisition/undertaking represents a significant change in the business activities of the entity. When a reporting entity evaluates whether a reconsideration event has occurred in an SPE that holds financial assets, the reporting entity should emphasize the significance of new acquisitions/undertakings relative to the current portfolio of the SPE's assets, including changes in the volatility or risk of the overall portfolio resulting from the new acquisitions/undertakings.

4.8.8 VIE reconsideration event – change in equity or expected losses

ASC 810-10-35-4(d)

The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses.

The previous two reconsideration events focus on events that may cause a voting interest entity to become a VIE. Alternatively, there may be situations in which a VIE could become a voting interest entity. This reconsideration event considers those situations in which an entity receives additional equity investments that potentially increase the sufficiency of the equity at risk.

Additionally, if the entity modifies its activities in a way that decreases its expected losses, equity at risk that was once deemed insufficient may become sufficient under Characteristic 1.

4.8.9 VIE reconsideration event – equity group at risk loses power

ASC 810-10-35-4(e)

Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

Under the VIE model, an entity will become a VIE if, as a result of changes in facts and circumstances, the group of at-risk equity investors lose the power through voting or similar rights to direct the activities of the entity that most significantly impact its economic performance.

4.8.10 VIE reconsideration in bankruptcy

Generally, when an entity files for bankruptcy protection, the group of at-risk equity investors lose the power to make decisions that have a significant impact on the economic performance of the entity.

Decision making over an entity that is in bankruptcy typically transfers to the bankruptcy court or creditor committee while the entity is in the process of reorganizing or liquidating. Therefore, we believe that the act of filing for bankruptcy typically constitutes a reconsideration event under the VIE model.

Similarly, when an entity emerges from bankruptcy, this would generally represent an event that requires reconsideration of entity's status as a VIE. This is due to the fact that the entity's governing documents and contractual arrangements are typically modified in a manner that impacts the sufficiency and characteristics of the entity's equity investment at risk.

4.8.11 VIE reconsideration – decision maker/service provider changes

As discussed in CG 3.4.3, the VIE model does not specify whether the determination of whether a decision maker or service provider arrangement is a variable interest should be reassessed upon the occurrence of a reconsideration event or on a continuous basis.

We believe that reconsideration of whether or not a decision maker or service provider arrangement is a variable interest is a policy choice. If such arrangements are evaluated on a continuous basis, a change in the conclusion as to whether the decision maker or service provider's arrangement is a variable interest could trigger a reconsideration event of the entity as described in ASC 810-10-35-4. If a policy to reassess on a continuous basis is elected, the ongoing assessment should focus on identifying changes that have occurred that would cause the decision maker to begin acting as a principal when it was previously determined to be acting as an agent, or vice versa.

We do not believe the introduction of new terms in similar structures or an increase in new market entrants (which would put downward pressure on fees) would change a service provider's decision-making philosophy (i.e., incentivize the service provider to begin acting in the capacity of a principal). Therefore, absent a modification of the contractual terms, we would not expect a reassessment of the At Market and Commensurate criteria as part of this ongoing reassessment.

We would, however, expect a reporting entity that has made a policy election to reassess its decision maker or service provider fee on an ongoing basis to re-evaluate the significance of its other economic interests at each reporting date. We believe a decision maker should focus on its acquisition of other economic interests, including direct and indirect variable interests, each time this reassessment is performed. In addition, we believe the decision maker should also re-evaluate whether a change in the fair value of its economic interests has occurred since the prior reassessment date. If the fair value of the decision maker's other economic interests have decreased from significant to worthless, we would view this to be the equivalent of in-substance disposition of that interest.

Conversely, we would view an increase in the fair value of the decision maker's other economic interest from insignificant to significant as an in-substance acquisition of additional interests. In both cases, we believe these events could change the behavior of the decision maker and potentially causes its decision-making philosophy to migrate from that of a principal to an agent, or vice versa.

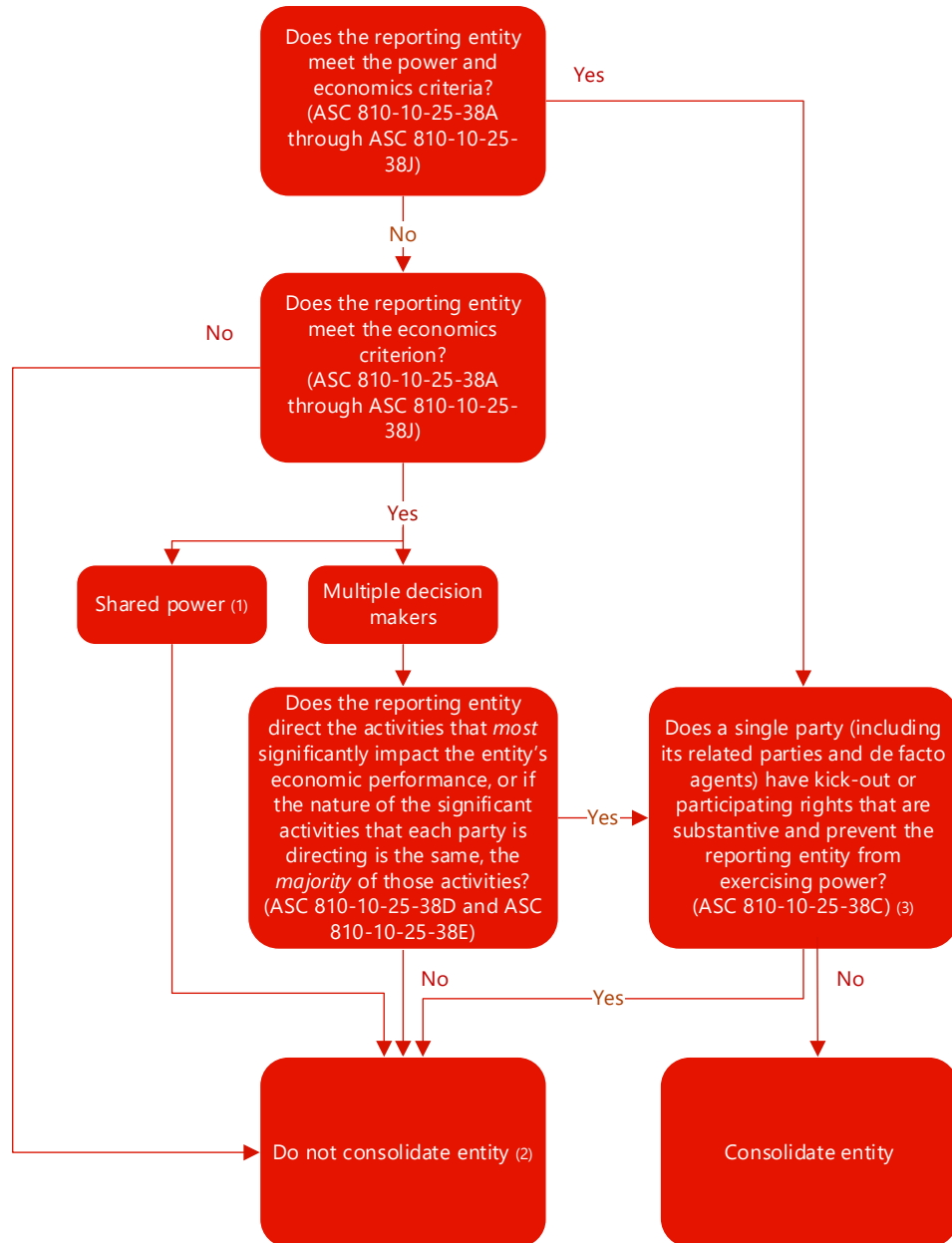
***Chapter 5:
Identifying the primary
beneficiary of a VIE–
updated January 2023***

5.1 Identifying the primary beneficiary of a VIE

The primary beneficiary is the reporting entity that is required to consolidate the VIE. The analysis required to determine which entity has a controlling financial interest and is the primary beneficiary of a VIE is predominantly qualitative. The primary beneficiary is the variable interest holder that has both (1) the power to direct activities that most significantly impact the economic performance of the VIE and (2) the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE. A reporting entity may also be the primary beneficiary if it is part of a related party group that meets both of the above criteria. A reporting entity is required to reconsider whether it is the primary beneficiary of a VIE on an ongoing basis.

Figure CG 5-1 provides a general overview of the primary beneficiary analysis from the reporting entity's perspective (excluding related party considerations). Refer to Figure CG 5-2 for a general overview of the primary beneficiary analysis including related parties.

Figure CG 5-1
General overview of the primary beneficiary analysis



(1) Shared power only exists when two or more unrelated parties together have the power to direct all of the significant activities of the entity. At the 2014 AICPA Conference on Current SEC and PCAOB Developments, Chris Rogers noted that if the reporting entity has unilateral power over **one more** of the significant activities than the other variable interest holder(s), shared power does not exist and the reporting entity has relative power and should consolidate the entity. See CG 5.2.4 for more information.

(2) A variable interest holder may hold economic interests in a VIE that are disproportionately greater than its stated power to direct the VIE's activities. The VIE model calls for increased skepticism in these situations, as noted in ASC 810-10-25-38G. For example, assume that Investor A and Investor B each contribute 50% of the equity to an entity, with each investor receiving 50% of the voting rights. The initial capital structure is comprised of (1) this equity contribution, which represents 3% of the initial funding, and (2) a loan provided by Investor A representing the remaining 97%. In a scenario such as this when Investor A's total economic interest is so disproportionate to its stated power (through voting rights), it may be appropriate for Investor A to consolidate the VIE. See CG 5.2.11 for more information.

(3) If the reporting entity concluded that there are multiple decision makers and the reporting entity directs the activities that *most* significantly impact the entity's economic performance (or if the nature of the activities are the same, it directs the *majority* of those activities), we would not expect that another single party investor would have participating rights that would prevent the reporting entity from exercising power (like it may with kick-out rights). See CG 5.3.4 for more information on how participating rights impact the power criterion.

5.1.1 **What is a primary beneficiary**

Once a reporting entity determines that it has a variable interest in a VIE, it must determine whether it is the primary beneficiary. A primary beneficiary (PB) is the reporting entity that holds a controlling financial interest in a VIE and thus is required to consolidate the entity. The VIE model requires a reporting entity with a variable interest in a VIE to qualitatively assess whether it has a controlling financial interest in the entity. This approach is intended to encourage the use of judgment in determining which reporting entity controls a VIE.

Excerpt from ASC 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 the VIE that most significantly impact the VIE's economic performance.

ASC 810-10-25-38B

A reporting entity must identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. A reporting entity's ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE.

A reporting entity is deemed to be the primary beneficiary of a VIE if it meets both criteria below:

- Power Criterion: Power to direct activities of the VIE that most significantly impact the VIE’s economic performance (“power criterion”).
- Losses/Benefits Criterion: Obligation to absorb losses from or the right to receive benefits of the VIE that could potentially be significant to the VIE (“losses/benefits criterion”).

In assessing whether a reporting entity meets both the power and the losses/benefits criteria, the VIE’s purpose and design, including the risks the entity was designed to create and pass through to its variable interest holders, should be considered. A reporting entity should also consider the variable interests of any related parties, including de facto agents, in this assessment. Refer to CG 5.4 for discussion on related parties.

Only one reporting entity (if any) should be identified as the primary beneficiary of a VIE. Although more than one reporting entity could meet the losses/benefits criterion, only one reporting entity (if any) will have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.

The VIE model requires an ongoing reconsideration of the primary beneficiary of a VIE. There are many reasons why there could be a change in the primary beneficiary. For example, a change might result from a transfer of power from one reporting entity to another. Some examples of when this might occur include:

- the expiration of kick-out rights or participating rights,
- the realization of a contingent event that causes kick-out rights or participating rights to become exercisable, and
- an acquisition of interests or contractual arrangements that allow a party to exercise power over the entity.

Question CG 5-1

Will a VIE always have a primary beneficiary?

PwC response

Under certain scenarios, none of the variable interest holders may be deemed to be the primary beneficiary and therefore no one would consolidate the VIE. For example:

- The party that meets the power criterion may not hold a potentially significant variable interest in the VIE (i.e., it does not meet the losses/benefits criterion).
- Power is shared among multiple unrelated parties.
- Power is not shared, but multiple unrelated parties direct the same activities that most significantly impact the entity’s economic performance, and no single party directs the majority of these activities.

5.2 Primary beneficiary—power criterion

For a reporting entity to determine whether it has the power to direct the activities of the VIE that most significantly impact the VIE's economic performance, it must first identify which activities are significant, and then determine who has the power to direct those activities.

5.2.1 Identifying the VIE's most significant activities

Determining which activities most significantly impact a VIE's economic performance can require significant judgment. First, a VIE's purpose should be considered, including the risks that it was designed to create and pass along to *all* its variable interest holders. Next, the reporting entity should identify the activities of the VIE that significantly impact these risks. The activities of a VIE that give rise to, or stem from these risks generally impact the economic performance of the entity in a significant manner. Lastly, the reporting entity should determine which party has the ability to direct the activities identified that *most* significantly impact the VIE's economic performance.

5.2.2 Decisions that most significantly impact performance

Once the most significant activities of the VIE have been identified, an analysis should be performed to understand the decisions related to those activities that *most* significantly impact the VIE's economic performance. The party who can make decisions over the significant activities that *most* significantly impact the VIE's economic performance would meet the power criterion. A variable interest holder is not required to have the power to direct *all* of an entity's significant activities in order to have power.

The VIE model does not specify how to determine whether one or more activities represent the *most* significant of the VIE's economically significant activities. A careful consideration of the following factors may prove helpful in considering which decisions most significantly impact the VIE's economic performance:

- How each decision impacts the risks that the VIE was designed to create and pass along to its variable interest holders
- How the decisions impact the cash flows of the VIE
- How the decisions impact operating margins of the VIE
- Whether such decisions could increase the VIE's revenues
- How the decisions could affect the overall fair value of the VIE
- The nature of the VIE's assets, and how the decisions could impact the fair value of those assets

In some cases, it may be obvious which activities and decisions most significantly impact a VIE's economic performance. In other cases, this analysis may be less clear. In those circumstances, judgment should be applied based on the facts and circumstances specific to the VIE, including its purpose and design and the risks it was intended to create and pass along to its variable interest holders.

As discussed in CG 4.4, an entity's significant activities must be identified for purposes of determining whether the entity is a VIE under Characteristic 2. As a general matter, we expect the significant activities of an entity to be the same for both analyses (i.e., the VIE and primary beneficiary

determinations). Refer to ASC 810-10-55-93 through ASC 810-10-55-205 for examples illustrating the application of the power criterion. Examples of common significant activities of entities by industry can also be found in CG 4.4.1.

5.2.3 *Impact of financial responsibility in assessing power*

The VIE model requires that implicit and explicit financial responsibilities be considered in the primary beneficiary analysis.

ASC 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.

Determining whether a reporting entity has an implicit financial responsibility to ensure that a VIE operates as designed requires judgment, including consideration of the entity's purpose and design. We believe the determination of what constitutes an implicit financial responsibility should consider the likelihood of all potential events.

Although a variable interest holder's involvement in the design of a VIE is not determinative that it has power over the entity, its involvement may demonstrate that it had the opportunity and incentive to establish arrangements to provide it with power. Such situations require a careful review of the entity's governing documents to determine whether that variable interest holder truly has power.

If the ongoing decisions of a VIE do not significantly impact its economic performance (i.e., they are purely administrative in nature), then the predetermined decisions made at formation are likely more relevant to the power analysis. Examples of such activities may include the selection of assets to be purchased by the entity, what will occur when the entity is dissolved, and the rights of the various parties. Refer to CG 5.2.7 for further discussion around entities with limited or no ongoing significant activities.

5.2.4 *Shared power among unrelated parties*

In certain situations, the power to direct a VIE's most significant activities may be shared among unrelated parties. In those situations, no party would be deemed the primary beneficiary of the VIE.

Excerpt from ASC 810-10-25-38D

If a reporting entity determines that power is, in fact, shared among multiple unrelated parties such that no 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.

Power is shared if two or more unrelated parties together have the ability to direct the activities of a VIE that most significantly impact the VIE's economic performance. This is often the case when each party is required to consent to decisions relating to those significant activities, assuming the consent requirement is substantive.

This principle is illustrated in the example included in ASC 810-10-55-182 through ASC 810-10-55-192. In that example, two unrelated companies are each responsible for manufacturing, distributing, and selling a product and are required to obtain each other's consent with respect to the decisions relating to those activities. If two or more unrelated parties are required to vote on (i.e., consent to) all decisions that significantly impact the VIE's economic performance, power is shared.

Question CG 5-2

If all parties involved with a joint venture that is a VIE must consent to all decisions that most significantly impact the VIE's economic performance, would it be appropriate to conclude that the VIE does not have a primary beneficiary?

PwC response

It depends. When a joint venture is a VIE and the venture partners are not related parties, no primary beneficiary will exist if *all* activities that significantly impact the VIE's economic performance require the consent of each of the venture partners. If the venture partners are related parties or de facto agents (refer to CG 5.4), then one of the venture partners will be required to consolidate the VIE if power over all of the VIE's significant activities is shared. The evaluation of circumstances when power is shared among related parties is discussed in further detail in CG 5.7.1.

Circumstances may arise when some but not all of a VIE's significant activities require the consent of two or more unrelated parties. Although some have interpreted the use of "most" in ASC 810-10-25-38D to mean majority, thereby suggesting that power is shared when a VIE's economically significant activities that are responsible for driving a *majority* of its economic performance require the consent of two or more unrelated parties, we believe shared power does not exist unless the consent of each party believed to share power is required for all of the VIE's most significant activities. Although the consent of two or more unrelated parties may be required for a majority, but not all of a VIE's most significant activities (e.g., two out of three of the VIE's significant activities identified), the ability of one party to unilaterally direct a single significant activity may call into question whether power over the VIE is in fact shared, as discussed in Chris Rogers' speech at the 2014 AICPA Conference on Current SEC and PCAOB Developments.

In those situations, the party with the ability to unilaterally direct the VIE's other significant activity would wield incremental power relative to the other party or parties believed to share power. This "relative power" model may suggest that the party with the ability to unilaterally direct a single significant activity of the VIE has power over the entity and may be the VIE's primary beneficiary.

5.2.4.1 *Shared power—unrelated parties: majority vs. unanimous consent*

In some situations, the decisions that most significantly impact the economic performance of an entity that is a VIE may require the approval of a *majority* of the parties involved with the VIE. We believe the unanimous consent of all parties involved is required to demonstrate that power is shared when two or more unrelated parties direct the significant economic activities of the VIE. If all of the unrelated parties are required to consent to decisions related to the VIE's most significant activities, we believe power would be shared.

5.2.5 *Unrelated parties direct same activities—power not shared*

If a conclusion is reached that power is not shared, but the same activities that most significantly impact the VIE's economic performance are performed by multiple unrelated parties, then the party with the power over the majority of those significant activities will meet the power criterion. However, if no party has power to unilaterally direct a majority of the VIE's significant activities, then no party will meet the power criterion.

Excerpt from ASC 810-10-25-38D

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 characteristics in paragraph 810-10-25-38A(a).

This principle is illustrated in the example included in ASC 810-10-55-194 through ASC 810-10-55-196. In that example, two unrelated parties are individually responsible for manufacturing, distributing, and selling a product (i.e., the VIE's significant activities) in different locations, and neither is required to obtain the other's consent over decisions relating to the significant activities for which it is responsible. If one party directs a majority of the entity's significant activities, then that party would be the VIE's primary beneficiary. We believe it would be rare that neither party direct a majority of the entity's significant activities if there are only two parties involved that direct the same activities.

This principle may also apply when analyzing securitization vehicles for consolidation. For example, three separate parties may be responsible for servicing separate and distinct pools of assets held as collateral by the securitization vehicle.

Consider a situation in which three companies (Company A, B, and C) each perform servicing of the mortgage loans in a mortgage loan securitization. Each company can make servicing decisions independently (i.e., without the consent of any other party). Servicing of the mortgage loans is determined to be the activity that most significantly impacts the economic performance of the VIE. If neither Company A, B, nor C are responsible for servicing a majority of the mortgage loans held by the VIE, then no party may have power over the entity.

Example CG 5-1 illustrates the evaluation of the impact of a change in power due to the passage of time.

EXAMPLE CG 5-1**Evaluating the impact of a change in power due to the passage of time**

Company X owns a power plant. Company A and Company B purchase outputs from Company X under power purchase agreements (PPAs). Company X is determined to be a VIE and both Company A and Company B's PPAs are determined to be variable interests. The estimated life of the power plant is 30 years.

Company A's PPA provides it with the contractual right to operate the power plant for the first 15 years of the power plant's life, while Company B's PPA provides it with the contractual right to operate the power plant for the remaining 15 years. The power granted to Company A and Company B through their PPAs is determined to provide them with the power to direct the activities of Company X that will most significantly impact the economic performance of Company X during the effective periods of their contracts.

Which company would be deemed to meet the power criterion?

Analysis

While both Company A and Company B's variable interest provide them with the power to direct the significant activities of Company X, Company B's power does not become effective until Company A's power ceases. In these situations it may likely be determined that Company A meets the power criterion during the term of its PPA, while Company B will meet the power criterion once Company A's PPA has expired and Company A no longer has a variable interest in Company X.

5.2.6 Unrelated parties direct different activities—power not shared

If the activities that significantly impact the VIE's economic performance are directed by multiple unrelated parties, and the nature of the activities each party is directing are different, then the reporting entity should identify which party has the power to direct the activities that *most* significantly impact the VIE's economic performance. One party will have the ability to direct the *most* significant activities, and that party will meet the power criterion.

Example CG 5-2 and Example CG 5-3 illustrate the impact of multiple unrelated parties concurrently directing different significant activities.

EXAMPLE CG 5-2**Multiple unrelated parties concurrently direct different significant activities**

Fruit Co. and Bottle Co. (unrelated parties) form Juice Co. Both Fruit Co. and Bottle Co. contribute an equal amount of cash and receive a 50% equity interest in Juice Co. Fruit Co. is an agricultural company specializing in the production of organic fruit used in high-end fruit drinks. Bottle Co. bottles and distributes beverages.

Fruit Co. and Bottle Co. formed Juice Co. for the purpose of manufacturing organic fruit juices for distribution to retailers throughout the US. Juice Co. has been determined to be a VIE. Profits and losses of Juice Co. will be allocated equally to Fruit Co. and Bottle Co. based on their relative ownership percentages. Apart from their equity interest, neither Fruit Co. nor Bottle Co. holds any other variable interest in Juice Co.

How should Fruit Co. determine if it meets the power criterion?

Analysis

First, Fruit Co. must determine the purpose and design of Juice Co., including the risks it was designed to create and pass through to its variable interest holders. Juice Co. was created to provide Fruit Co. access to Bottle Co.'s low-cost bottling process and distribution network, while providing Bottle Co. access to Fruit Co.'s supply of organic fruit.

Next, Fruit Co. must determine which activities of Juice Co. most significantly impact its economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would meet the power criterion.

Fruit Co. has determined the agricultural activities (i.e., the growth of the core ingredient in Juice Co.'s primary product) have a more significant impact on the economic performance of Juice Co. than the production/bottling and distribution activities combined.

In this example, agricultural decisions most significantly impact Juice Co.'s economic performance. Since Fruit Co. unilaterally directs agricultural activities, it would meet the power criterion. Even if Bottle Co. directs more significant activities in absolute terms, those activities do not represent Juice Co.'s most significant activities.

EXAMPLE CG 5-3

Multiple unrelated parties concurrently direct different significant activities

Fruit Co. and Bottle Co. (unrelated parties) form Juice Co. Both Fruit Co. and Bottle Co. contribute an equal amount of cash and receive a 50% equity interest in Juice Co. Fruit Co. is an agricultural company specializing in the production of organic fruit used in high-end fruit drinks. Bottle Co. bottles and distributes beverages.

Fruit Co. and Bottle Co. formed Juice Co. for the purpose of manufacturing organic fruit juices for distribution to retailers throughout the U.S. Juice Co. has been determined to be a VIE. Profits and losses of Juice Co. will be allocated equally to Fruit Co. and Bottle Co. based on their relative ownership percentages. Apart from their equity interest, neither Fruit Co. nor Bottle Co. holds any other variable interest in Juice Co.

How should Fruit Co. determine if it meets the power criterion?

Analysis

First, Fruit Co. must determine the purpose and design of Juice Co., including the risks it was designed to create and pass through to its variable interest holders. Juice Co. was created to provide Fruit Co. access to Bottle Co.'s low cost bottling process and distribution network, while providing Bottle Co. access to Fruit Co.'s supply of organic fruit.

Next, Fruit Co. must determine which activities of Juice Co. most significantly impact its economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would meet the power criterion.

Fruit Co. has determined the activities which most significantly impact Juice Co.'s economic performance are as follows:

Activity

Agricultural

Production/Bottling

Distribution

Next, Fruit Co. must determine which party has the power over the activities that most significantly impact the economic performance of Juice Co. Fruit Co. has determined the parties with the power to direct activities which most significantly impact Juice Co.'s economic performance as follows:

Activity	Responsible party
Agricultural	Fruit Co.
Production/Bottling	Bottle Co.
Distribution	Bottle Co.

If each of the significant activities identified above carried the same importance in determining Juice Co.'s economic performance (which may be very difficult to demonstrate in practice), Bottle Co. would be deemed to meet the power criterion as it has the power to direct more of the activities that *most* significantly impact the economic performance relative to Fruit Co.

5.2.7 ***VIEs with limited or no ongoing significant activities***

Highly structured entities with limited activities (e.g., securitization vehicles and special purpose entities) may be established with all key decisions predetermined at formation. The remaining activities conducted by the VIE throughout its life may be limited to activities that are purely administrative in nature (e.g., collecting and distributing cash to the interest holders). When such activities do not significantly impact the economic performance of the VIE, questions may arise as to which party, if any, has power over the VIE.

If a VIE was established to have a limited life with *no* significant ongoing decision-making requirements, we believe the power analysis should focus on the key decisions of the VIE that were made at formation (or upon the redesign of the entity). Determining which variable interest holder, if any, has power requires consideration of the purpose and design of the VIE, each party's involvement in determining the VIE's activities, and how those activities will be carried out. A variable interest holder's involvement in the design of the VIE may indicate that it has the opportunity and incentive to establish arrangements through which it can exercise power over the VIE. We believe a variable interest holder's incentive to establish arrangements through which it can exercise power will increase as its exposure to the VIE's benefits and losses increases.

When a VIE's ongoing decision making relates to activities that significantly impact the economic performance of the VIE, an analysis should be performed to determine which party can direct such

activities. In circumstances when the VIE's ongoing activities are limited to a single significant activity, we believe the party with power over that activity would likely meet the power criterion, although each variable interest holder's involvement in the design of the VIE should also be considered.

The analysis described above should consider each variable interest holder's current ability to exercise power, even though they may not actively do so.

5.2.8 Significant decisions made upon a contingent event

The analysis to determine which reporting entity can make the most significant decisions of the entity becomes challenging when one or more of the significant decisions are only made upon the occurrence of a contingent event(s). In addition to considering the purpose and design of the entity and its significant activities, the reporting entity should consider the likelihood of the contingent event occurring, including the reporting entity's ability to influence the occurrence of the contingent events. The greater the likelihood of the contingent event occurring, the more weight should be given to those contingent significant decisions when making the determination as to which reporting entity can make the most significant decisions. The reporting entity should also consider whether the contingent significant decisions can be made concurrent with other significant decisions of the entity (e.g., servicing of performing loans and servicing of loans in default) or whether the contingent significant decisions can only be made in sequence and are dependent on the success of previous significant decisions (e.g., research and development activities followed by production and marketing activities).

In situations where the contingent significant decisions can be made concurrent with other significant decisions, the assessment of which reporting entity has the power should consider all significant decisions, including the contingent significant decisions and their likelihood of occurring. The reporting entity with the ability to make the most significant decisions of the entity would meet the power characteristic. Because the assessment of power considered all significant decisions, including the contingent ones, there would likely not be a change in the determination of which reporting entity met the power criterion when the contingencies are resolved.

In situations when the contingent significant decisions are made in sequence and dependent on the success of previous significant decisions, the assessment of which reporting entity has the power over the most significant decisions of the entity should first focus on the likelihood of the contingent significant decisions being made. If it is unlikely, the assessment of the most significant decisions should only consider the current significant decisions until the contingency has occurred. The reporting entity with the ability to make the current significant decisions would likely meet the power characteristic. In these situations, there would likely be a change in the reporting entity with power if a different reporting entity is able to make the significant decisions once the contingency occurs.

Alternatively, if it is likely or relatively certain that the contingent significant decisions will be made, the assessment of the most significant decisions should include all significant decisions, including the contingent ones, in a manner similar to the evaluation of concurrent contingent significant decisions. These assessments are described in:

- Example CG 5-4, Assessing the impact of activities that are contingent upon a future event
- Example CG 5-5, Multiple unrelated parties sequentially direct different activities
- Example CG 5-6, Multiple unrelated parties sequentially direct different activities when there is significant uncertainty

- Example CG 5-7, Evaluating the impact of a contingent shift in power

EXAMPLE CG 5-4

Assessing the impact of activities that are contingent upon a future event

A VIE is created for the purpose of purchasing commercial mortgage loans from a third-party transferor. The VIE finances the purchase of the commercial mortgage loans by issuing fixed-rate debt to third-party investors, and equity to a third party that will also perform special servicing. The transferor retains primary servicing responsibilities over the mortgage loans. Upon the occurrence of a delinquency or default of a mortgage loan, the administration of the loan is transferred to the special servicer. In assessing the purpose and design of the entity, it was concluded that the servicing of loans that are delinquent or in default is the only ongoing significant activity of the VIE.

Which party has the power to direct the activities of the VIE that most significantly impact its economic performance?

Analysis

In this example, the VIE's activities that most significantly impact its economic performance involve the management of assets that are delinquent or go into default, which is the responsibility of the special servicer. Although the special servicer cannot exercise power over this activity until a contingent event occurs (i.e., the default or delinquency of the mortgage loans), the special servicer would likely be deemed to have power, as this activity has the most significant impact on the VIE's economic performance.

The special servicer would be deemed to have power because the activity of managing assets that go into default is likely to occur and can also occur concurrent with all other significant activities. Therefore, this activity is included in the assessment of which activities most significantly impact the economic performance of the entity.

EXAMPLE CG 5-5

Multiple unrelated parties sequentially direct different activities

An entity is formed by Company A and Company B for the purpose of building a manufacturing facility. Company A and Company B each own a 50% equity interest in the entity, which was determined to be a VIE. Once construction is complete, the VIE will operate the facility and sell the manufactured goods to third parties unrelated to Company A and Company B. Company A is responsible for directing the significant activities during the construction of the manufacturing facility, while Company B will direct the significant activities related to manufacturing and sales of the finished product after construction of the facility is complete. All the appropriate approvals for the manufacturing site have been obtained (e.g., permits). Company A and Company B have collaborated on similar projects in the past with each party having the responsibility for similar activities. In each case, the construction phase was successfully completed in accordance with the business plan. In addition, Company B was able to begin manufacturing and selling the finished product in accordance with the entity's original business plan.

The decisions made during both the construction phase and the subsequent manufacturing and sales stage are determined to have a significant impact on the economic performance of the entity. Neither Company A nor Company B have any other variable interests in the VIE.

Which party would be deemed to meet the power criterion?

Analysis

Given Company A's positive historical experience in completing similar projects and the expectation that construction will be successfully completed, Company B may be deemed to meet the power criterion throughout the life cycle of the entity (even during the construction phase) since the activities over which it has power (manufacturing and sales) are more likely key drivers of the entity's economic performance. Even though the significant activities are sequential and the manufacturing and sales activities are dependent on the successful completion of the construction activities, the significant activities in both phases should be included in the assessment of power.

If, on the other hand, significant uncertainties existed with respect to the construction (e.g., zoning and design issues) and/or Company A did not have positive historical experience in successfully completing similar projects, Company A may be deemed to meet the power criterion during the construction phase with the power shifting to Company B at or near completion. In this case, only the construction activity would be included in the initial assessment of which reporting entity can make the most significant decisions of the entity since there is significant uncertainty about the completion of the construction phase of the project.

EXAMPLE CG 5-6

Multiple unrelated parties sequentially direct different activities when there is significant uncertainty

An entity is formed for the purpose of developing, manufacturing, and distributing a pharmaceutical drug candidate. The entity is determined to be a VIE. The VIE obtains legal title to the drug candidate and plans to perform further research and development in order to obtain approval from the FDA for commercialization of the drug. The drug is currently in Phase I clinical trials and there is significant uncertainty regarding the likelihood of the drug reaching FDA approval.

Company A, a variable interest holder, is responsible for all decisions regarding the activities of the VIE throughout the FDA approval process. Company B, a variable interest holder, will be responsible for all significant activities once FDA approval is received, including manufacturing, marketing, and distribution of the drug. It is determined that the activities performed during both the initial stage (research and development) and subsequent stage (manufacturing, marketing, and distribution) will have a significant impact on the economic performance of the VIE.

Which party would be deemed to meet the power criterion?

Analysis

Both Company A and Company B have the power to direct significant activities of the VIE that will impact its economic performance. However, Company B's power is contingent upon the successful development of the drug and receipt of the required approvals.

Since there is significant uncertainty regarding FDA approval at the assessment date, and the manufacturing, marketing, and distribution activities are sequential and dependent on the success of the research and development activities, the determination of power should be based on the significant activities that exist during the initial stage (i.e., research and development activities). Therefore, it is likely that Company A would meet the power criterion during the initial stage since it has the power to

direct the activities that will have the most significant impact on the VIE's economic performance during that initial stage.

Once the uncertainty regarding the receipt of FDA approval has lapsed, the determination of which variable interest holder meets the power criterion should focus on which party has the power to direct the significant activities during the remaining life of the entity (i.e., manufacturing, marketing, and distribution), which is likely to be Company B in this example. In other words, once the FDA approval contingency has been met, it is likely that the party determined to meet the power criterion will change.

EXAMPLE CG 5-7

Evaluating the impact of a contingent shift in power

A VIE is created for the purpose of purchasing fixed-rate residential mortgage loans from a transferor. The entity finances the purchase of the mortgage loans by issuing three tranches of securities, a senior tranche that is guaranteed by an unrelated financial guarantor (FG Company), a subordinate tranche, and a residual interest. The transferor (and holder of the residual interest) retains servicing responsibilities over the mortgage loans. Upon a substantive predefined event of default (which is triggered based upon a significant amount of delinquencies of the underlying assets), FG Company has the right to remove the transferor and assume the role of servicer.

Which party would be deemed to meet the power criterion?

Analysis

As servicer, the transferor is responsible for servicing the non-performing loans, which includes contacting borrowers in default, determining if and when a borrower should be granted a loan modification, as well as determining when to foreclose on the collateral underlying a delinquent mortgage loan. Based on the purpose and design of the VIE, servicing of non-performing loans may be determined to have the most significant impact upon the economic performance of the entity. If that is the case, the transferor, in its role as servicer, would meet the power criterion.

However, once the predefined event of default is triggered, FG Company would meet the power criterion. FG Company would be deemed to meet the power criterion because it would have the ability to replace the transferor as servicer at any time once the predefined event of default is triggered. As a result, there would be a change in the party with power.

5.2.9 Power—board governance and separate venture partner contract

If an entity is governed by a board of directors and one of the venture partners has the ability to make decisions through a separate arrangement (e.g., a management contract, managing member interest, or general partner interest), an analysis should be performed to determine at what level power is exercised (i.e., by the VIE's board of directors or the manager/managing member/general partner). To make this determination, a reporting entity should consider, among other things, the following:

- At what level the significant decisions of the VIE are made
- At what level the significant activities of the VIE are carried out

- Whether the board makes decisions at a granular level, thereby establishing narrow parameters that the manager must operate within when carrying out decisions made by the board
- Whether decisions made by the board are at a high level, thereby giving the manager significant latitude and discretion in carrying out such decisions
- If the board directs the entity's most significant activities, whether each party is required to consent to the decisions made by the board that relate to the VIE's significant activities

If the entity's significant operating and capital decisions are made by the board, then the manager would not have power. In such cases, the manager would generally have limited authority as to how such decisions are carried out. In other words, the manager would be acting as an agent of the board. This is often the case when decisions made by the board are detailed and narrow parameters are specified as to how such decisions should be implemented.

Alternatively, if decisions made by the board are very high level in nature and the manager (1) makes decisions that most significantly impact the entity's economic performance, or (2) has significant discretion carrying out decisions made by the board, then the manager may have power.

This analysis becomes more challenging when the VIE outsources decision making to one of the venture partners through a separate contractual arrangement. In such situations, an analysis must be performed to determine whether that venture partner is able to exercise power over the entity.

Example CG 5-8 illustrates the determination of whether power is shared through an entity's board of directors when an entity's day-to-day operations are managed by one of the venture partners.

EXAMPLE CG 5-8

Determining whether power is shared through an entity's board of directors when an entity's day-to-day operations are managed by one of the venture partners

Company A and Company B, unrelated parties, form a new entity, Company X. Company X is governed by its board of directors, which consists of four directors, two appointed by each party. All significant decisions of Company X are made by its board of directors and require the consent of both Company A and Company B.

Company X also entered into a contractual arrangement with Company B to manage Company X's day-to-day operations. Company B's decision-making ability is limited to carrying out operating decisions approved by Company X's board. Company X's board is actively involved in overseeing the operations of Company X. The board's decisions are specific and its operating and capital budgets are prepared and approved at a granular level. Company B is not able to unilaterally direct any of Company X's significant activities through the management agreement.

Does Company B meet the power criterion by virtue of its separate management agreement?

Analysis

No. The significant decisions of Company X are made by its board of directors. In addition, these decisions are made at a granular level. Since Company B's day-to-day operating activities are limited to carrying out the significant decisions made by the board and Company B is not able to unilaterally

direct any of the board's decisions, Company B does not have power. Rather, power would be considered shared since the board has power and any significant decisions made by the board require the consent of both Company A and Company B.

In many situations where the consent of two or more parties is required in order for an entity to make a decision, the governing documents contain dispute resolution provisions clarifying what process will be undertaken if a "deadlock" occurs (i.e., when the parties are unable to agree on a specific decision or course of action). If one of the parties can break the deadlock by casting a tie-breaking vote, it may be deemed to have the power over the entity and power would not be considered shared.

5.2.10 Decision making is outsourced through a third-party contract

There may be circumstances where a single decision maker can direct the activities of the VIE that most significantly impacts its economic performance through a management or services contract. If the decision-making contract does not qualify as a variable interest, then the decision maker or service provider should be presumed to be acting in an agency capacity on behalf of the VIE's interest holders. In other words, the decision maker or service provider would not have power because it is acting in a fiduciary capacity. Refer to CG 3.4 and CG 5.5.4 for further detail regarding the evaluation of decision maker or service provider fee arrangements. In such cases, a reporting entity should assess power held by interest holders other than the outsourced decision maker to determine whether or not there is a primary beneficiary. For example, if the decision maker is acting in an agency capacity, the equity holders at risk may be deemed to have the power to direct the VIE's most significant activities. If a single equity holder at risk has power through holding the majority voting interest in the VIE, we believe that equity holder at risk may have power provided the other equity holders at risk do not have substantive participating rights. If a single equity holder at risk (or a related party group of equity holders at risk with majority voting interest) does not have the ability to exercise power, we believe there would be no primary beneficiary.

Example CG 5-9 illustrates the assessment of outsourced decision-making arrangements when the fee does not represent a variable interest.

EXAMPLE CG 5-9

Assessing outsourced decision-making arrangements when the fee does not represent a variable interest

A VIE is created for the purpose of purchasing fixed-rate residential mortgage loans from a transferor. The entity finances the purchase of the mortgage loans by issuing three tranches of securities, a senior tranche, a subordinate tranche, and a residual interest. The transferor that holds the residual interest directs the VIE to engage Reporting Entity as servicer of the mortgage loans. In addition, Reporting Entity holds a small interest in the senior tranche of securities issued by the VIE. Reporting Entity determined it has "power" to make decisions that most significantly impact economic performance of the VIE through its servicing contract. Reporting Entity has determined that its service contract is not a variable interest despite the senior interest it holds in the entity when assessing under ASC 810-10-55-37 (see CG 3.4).

Would Reporting Entity be the primary beneficiary of the VIE?

Analysis

In this fact pattern, since the power exists in a contract that is not a variable interest, Reporting Entity would be viewed as acting as an agent for the other variable interest holders. Therefore, Reporting Entity would not be the primary beneficiary of the VIE. In some instances, the transferor may have the ability to remove and replace Reporting Entity as servicer without cause. In such cases, the transferor may be viewed as the primary beneficiary.

5.2.11 *Disproportionality—stated power vs. economic exposure*

In some cases, a variable interest holder may lack stated power while holding an economic interest in a VIE that exposes that variable interest holder to greater than a majority of the VIE's benefits and losses.

ASC 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.

The VIE model calls for increased skepticism in these situations. As the level of disparity between a variable interest holder's level of stated power and exposure to benefits and losses increases, so too should a reporting entity's level of skepticism about the substance of that variable interest holder's apparent lack of stated power. In these situations, judgment should be applied and an understanding of the purpose and design of the VIE will be necessary.

For example, assume that Investor A and Investor B each contribute 50% of the equity to an entity, with each investor receiving 50% of the voting rights. The initial capital structure is comprised of (1) this equity contribution, which represents 3% of the initial funding, and (2) a loan provided by Investor A representing the remaining 97%. In a scenario such as this when Investor A's total economic interest is so disproportionate to its stated power (through voting rights), it may be appropriate for Investor A to consolidate the VIE.

5.3 *Assessing rights held by non-decision makers*

In some circumstances, rights held by other variable interest holders should be considered to determine whether such rights convey power (i.e., kick-out or liquidation rights) or prevent a decision maker from exercising power (i.e., participating rights).

5.3.1 *Impact of kick-out rights in assessing the power criterion*

A reporting entity's determination of whether it meets the power criterion should not be impacted by the existence of kick-out rights unless a single reporting entity, including its related parties or de facto agents, has the unilateral ability to exercise those rights. Kick-out rights are defined as follows:

Definition from ASC 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.

Excerpt from ASC 810-10-25-38C

A reporting entity's determination of whether it has 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.

Kick-out rights would not impact a reporting entity's primary beneficiary assessment unless a single variable interest holder (including its related parties and de facto agents) can exercise a substantive kick-out right. If two or more unrelated parties are required to come together to exercise the kick-out right, it would not impact the power assessment. This definition and threshold differ from the approach used to assess whether a limited partnership is a VIE under Characteristic 2 and also the voting model described in CG 7.3.1. As noted above, a kick-out right may prevent a decision maker from exercising power over a VIE or convey power over an entity's most significant activities if that right allows the holder to permanently strip the decision maker of its decision-making authority.

Example CG 5-10 illustrates the evaluation of whether a kick-out right is substantive in the primary beneficiary analysis.

EXAMPLE CG 5-10**Evaluating whether a kick-out right is substantive in the primary beneficiary analysis**

A limited partnership was formed to develop and operate a mixed-use property. The general partner owns 12% of the outstanding partner interests, and the remaining 88% limited partner interests are held by third-party investors. The partners will fund their capital commitments over time as the property is constructed. Because the equity at risk was not sufficient to develop and operate the property, the LP was determined to be a VIE under Characteristic 1.

Although the general partner has the power to direct the VIE's most economically significant activities, the limited partners, through a simple majority vote, have the ability to replace the general partner anytime without cause.

Does the kick-out right held by the limited partners demonstrate that the general partner lacks the power to direct the VIE's most significant activities?

Analysis

No. If a single party has the power to direct a VIE's most significant activities, that power can be overcome by a kick-out right only when that kick-out right is currently exercisable by a single variable interest holder (including its related parties and de facto agents). Since the kick-out right in this

example requires the affirmative vote of a simple majority of the limited partners, it would not be considered substantive and the general partner would be deemed to have power over the entity.

Question CG 5-3

If a kick-out right is exercisable by an entity's board of directors, can the board be viewed as a single party when evaluating whether the kick-out right is substantive?

PwC response

A board is typically comprised of two or more individuals that have a fiduciary responsibility to the entity's shareholders (i.e., the board should be viewed as a proxy for the shareholder group). In many instances, the ability of the board to exercise a substantive kick-out or liquidation right should be viewed as if that right was exercisable directly by the shareholder group. Therefore, the ability of a board to exercise kick-out or liquidation rights will not influence which party, if any, has power unless a single party (and its related parties and de facto agents) has unilateral control over the board.

Example CG 5-11 illustrates the evaluation of a purchase and sale agreement with a non-refundable deposit.

EXAMPLE CG 5-11

Evaluating a purchase and sale agreement with a non-refundable deposit

Company A (reporting entity) enters into a purchase and sale agreement with Company X (entity) under which Company A will buy land and a building from Company X, its sole assets. As part of the agreement, Company A is required to pay a non-refundable deposit to Company X. Company A also has the right to terminate the contract, subject to the loss of its deposit. Assuming that Company A has a variable interest in Company X due to the purchase and sale agreement (see Example CG 5-1 for details), and that Company X is a VIE (see Question CG 4-6 for details), will Company A be considered to meet the power criterion due to its non-refundable deposit to Company X?

Analysis

Potentially. Company A will need to assess whether it has a controlling financial interest in Company X through an evaluation of both the power and losses/benefits criteria in ASC 810-10-25-38. In land purchase option agreements, the buyer may have the rights to decide on amenity and zoning density issues, or for rental property agreements, the buyer may have rights to control leasing decisions. To the extent the purchase and sale agreement transfers the rights to direct the activities that most significantly impact the economic performance of the VIE to the buyer, where the buyer also has a substantive non-refundable deposit, it is likely that the buyer would meet the power criterion.

5.3.2 *Evaluating when a kick-out right is substantive*

Although ASC 810-10-25-38C does not specifically state that a kick-out right must be substantive to influence which party has power over an entity, we believe the overarching concept of ASC 810-10 supports this view.

ASC 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

Reporting entities should look to ASC 810-10-25-14A when evaluating whether a kick-out right is substantive. We believe a determination should be made as to whether there are any barriers to exercising such rights, such as the following:

- Contractual—Conditions that make it unlikely that a kick-out right can be exercised (e.g., conditions that narrowly limit the timeframe in which the right may be exercised)
- Commercial—Financial penalties or operational barriers that act as significant disincentives for replacing the party
- Commercial—An inadequate number of qualified replacements for the party are available or compensation is inadequate to pay a qualified replacement
- Procedural or informational—The absence in the applicable agreements (or in the applicable laws or regulations) of an explicit, reasonable mechanism that allows the holder to exercise those rights or to obtain the information necessary to exercise them

In addition, a reporting entity should consider whether another variable interest holder has substantive participating rights (refer to CG 4.4). If a single party has substantive participating rights, those rights would prevent the holder of the kick-out right from exercising its power over the decision maker, and therefore no party would consolidate. In other words, the party with the participating rights will have the ability to block decisions related to all of the entity's most significant activities.

The above list is not all inclusive, and the facts and circumstances of each situation should be carefully considered. Refer to ASC 810-10-55-4N through ASC 810-10-55-4W for additional examples of how to assess kick-out rights.

5.3.3 Liquidation rights held by non-decision makers

The definition of a kick-out right also includes the ability to dissolve (liquidate) a VIE without cause. Accordingly, a single party (including its related party and de facto agents) with the ability to liquidate a VIE would meet the power criterion if that right is substantive.

The guidance is based on the notion that a single party's ability to liquidate a VIE produces the same outcome for the decision maker as exercising a kick-out right. That is, the decision maker will be

permanently stripped of its decision-making rights. The ability of the investors to obtain substantially all of the same specific assets under management and to find a replacement manager with sufficient skills to manage those assets is not relevant to the evaluation of a liquidation right.

As discussed in CG 4.4.5.5, we believe redemption rights are legally and economically different from liquidation rights. That is, a redemption right represents an obligation to return capital to an investor at the investor's request. If an investor exercises its redemption right, it generally will be unable to strip the decision maker of its power over the entity. Therefore, redemption rights should generally be disregarded when assessing the power criterion.

There may be certain cases where a redemption right is not substantively different from a liquidation right. This could be the case when a VIE has a single investor that could force a liquidation of the entity upon exercising its redemption right.

5.3.4 Impact of participating rights in assessing the power criterion

Participating rights are defined as the ability to block or participate in the actions through which a decision maker exercises the power to direct the activities of a VIE that most significantly impact the entity's economic performance.

Definition from ASC 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 should generally not be considered in assessing whether a decision maker has the power to direct activities that most significantly impact a VIE's economic performance unless the following conditions are met:

- The participating right is exercisable by a single variable interest holder (including its related parties and de facto agents)
- The participating right gives the single variable interest holder the ability to veto all decisions related to the VIE's most significant activities

Participating rights over decisions related to some of the significant activities may also be relevant when assessing relative power. Refer to CG 5.2.4 for further discussion on relative power.

Like a kick-out right, participating rights should be considered when assessing the power criterion only when they are substantive.

Question CG 5-4

If a single party can exercise substantive participating rights, would that variable interest holder meet the power criterion?

PwC response

Typically, no. Unlike a kick-out right, participating rights by themselves do not convey power. A participating right can only prevent another party from exercising power. This distinction is driven by the fact that a participating right limits the holder to *vetoing*, *blocking*, or *participating in* an action as opposed to *initiating* an action. For that reason, a substantive participating right typically only prevents another party from having power. However, there may be instances when substantive participating rights, when considered along with the variable interest holder's (or its related parties and de facto agents') other decision-making rights over significant activities, may result in that variable interest holder (or some other party in the related party group) having power.

The definition or threshold used to evaluate whether participating rights are substantive in the VIE model is not aligned with the voting model. Consequently, the impact of a participating right may produce different consolidation results under the VIE and voting models. See further discussion in CG 7.3.2.

Unlike a participating right, a protective right allows the holder to block or veto a decision or activity that is expected to occur outside the ordinary course of business (i.e., fundamental changes in the activities of an entity). Therefore, protective rights do not impact the power assessment as such rights are designed to protect the interest of the party holding the right(s).

Definition from ASC 810-10-20

Protective Rights (VIE definition): Rights are 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 franchisee agreement for which the entity is the franchise 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.

Determining whether a right is protective or participating is judgmental. Refer to CG 4.4 for further discussion.

5.3.5 Evaluation of call options in assessing the power criterion

Call options (i.e., the right to purchase equity interests held by an investor of an entity) are common in joint ventures and other types of co-investment structures. For example, one investor in a joint venture may grant another investor the right to purchase its equity interest for a fixed price, at fair value, or at a price determined based on a formula (i.e., a purchased call option from the option holder's standpoint). As a result of exercising the option, the holder (purchaser) of the call option may receive sufficient shares or equity to gain power over the entity.

Call options that require the writer of the option to deliver cash at settlement (net cash settled call options) do not convey power. The holder of the option will not gain the power to direct the activities that most significantly impact the VIE's economic performance upon settlement of the option since it does not receive equity interests or its associated rights. Therefore, net cash settled call options should be disregarded when performing the power assessment.

The VIE model does not specifically address how physically settled purchased call options that give the holder of the call the ability to exercise power over the VIE upon exercise should be considered. The ensuing discussion assumes the call option will be physically settled such that the shares underlying the option would allow the holder to exert power over the VIE upon exercise of the option and delivery of the shares. When evaluating whether the call option conveys power to the holder, the analysis should consider the voting rights exercisable through the shares underlying the option, as well as any other rights that may transfer to the holder upon exercising the option. While there are similarities between kick-out rights and call options, the holder of a call option is generally required to make a significant cash payment to exercise the option. Therefore, we believe call options are economically different from kick-out rights, except in cases when the cash payment is minimal (e.g., call options exercisable at a nominal strike price).

Call options should be carefully considered to determine if they provide the holder with power over the entity. We believe that the following factors should be considered in making this evaluation:

- Whether the option is currently exercisable. An option that is not currently exercisable, and only becomes exercisable upon a contingent future event or through the passage of time, would generally not be considered to provide the holder of the call option with power over the entity.
- The strike price and other key terms of the call option. If the call option has an exercise price at fair value, it would be unlikely that the call option in and of itself would provide the holder with power. However, if the option's exercise price is based on a fixed amount or an amount derived by a formula, the intrinsic value of the option should be considered. If the call option is deep in the money, the substance of the arrangement may provide the holder of the call option with power over the entity.
- The substance of the call option. If the call option can be exercised over some but not all of the remaining voting interests whereby the reporting entity obtains control of the VIE, it may indicate

that the holder of the call option has power. For example, if the reporting entity holds 49.9% of the voting shares and can exercise an option to acquire 0.2% of the voting shares, and thus obtain control of the VIE, the reporting entity should evaluate whether their call option is substantively a kick-out right. Whereas if the reporting entity could only exercise an option to acquire the entire remaining outstanding interest (as opposed to exercising in small increments), the call option may be less akin to a kick-out right.

- The overall level of control held by the holder of the option. The holder may have the ability to make decisions that most significantly impact the economic performance of the VIE through other variable interests held by the option holder (including its related parties/de facto agents).
- Barriers to exercise the option. Factors that could prevent or limit the ability of the option holder to exercise the call option (e.g., due to illiquidity, regulatory concerns, or other factors) may lead to a conclusion that the holder does not have the power over the VIE through the call option.
- Conditions that make exercise not prudent, feasible, or substantially within the control of the holder. For example, when the counterparty to the call option (i.e., the writer of the option) controls technology that is critical to the VIE or is the principal source of funding for the VIE.

The shares received as a result of the exercise of a purchased net share settled call option may provide the holder with power over the entity. When a net share settled option is exercised, it does not require any investment or outlay of cash by the holder. In these cases, the option holder often already has a sizeable investment in the entity.

When the holder of a call option is precluded from exercising the option until a future date (e.g., after 5 years) or a specific event occurs, the call option should not be considered when assessing the power criterion until it becomes exercisable.

Many of the criteria noted above require continuous monitoring by a reporting entity.

5.4 *Related parties—impact on the VIE model*

Related party relationships can play a critical role in the VIE model in two ways: (1) the determination of whether the entity is a VIE, and (2) the determination of a VIE's primary beneficiary, if one exists. For the purposes of the VIE model, the related party definition includes "de facto agency" relationships.

Related parties are defined in the Master Glossary.

Definition from the ASC Master Glossary

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.

The VIE model expands the traditional definition of related parties, as described in ASC 850, *Related Party Disclosures*, to include “de facto agents,” which are described in ASC 810-10-25-43.

Excerpt from ASC 810-10-25-43

All of the following are considered to be de facto agents of a reporting entity:

- a. A party that cannot finance its operations without subordinated financial support from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary
- b. A party that received its interests as a contribution or a loan from the reporting entity
- c. An officer, employee, or member of the governing board of the reporting entity
- d. A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party’s ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.
- e. A close business relationship like the relationship between a professional service provider and one of its significant clients

The intent of supplementing the traditional definition of related parties in the VIE model by including de facto agents was to prevent a variable interest holder from avoiding consolidation of a VIE by protecting its interest(s) or indirectly expanding its holdings through such agents. It is important to understand this rationale when evaluating the related party guidance in the VIE model, as the application of this guidance will often require judgment.

While the definition of a related party is well established, the concept of de facto agents is unique and merits further discussion. Some of the de facto relationships in the VIE model are relatively

straightforward. Parties are deemed to be de facto agents of a reporting entity if they (1) are financially dependent on the reporting entity; (2) receive the investment or the funds to make the investment from the reporting entity; or (3) are an officer, employee, or on the governing board of the reporting entity.

The other relationships that create a de facto agent require more judgment. A de facto agency relationship is created when a party cannot sell, transfer, or encumber their interests without the approval of the reporting entity (often referred to as “transfer restrictions”). However, mutual transfer restrictions do not cause a de facto agency relationship if both parties have the right of prior approval and the rights are mutually agreed terms by willing, independent parties. A de facto agency relationship is also created when a party provides a significant amount of professional services or other similar services to a reporting entity (“significant service provider”). Certain de facto agency relationships, including those established as a result of transfer restrictions and close business relationships, are more difficult to apply.

5.4.1 Related parties—transfer restrictions

Absent the de facto agency rules, a reporting entity could avoid consolidation of a VIE by “parking” its interests with a third party and controlling that party’s actions by restricting its ability to sell, transfer, or encumber its interest. We believe that the FASB’s rationale was to identify situations where the restricted party (the party that must obtain approval) is acting as an agent or de facto agent on behalf of another reporting entity or, in the case of cross transfer restrictions, where the reporting entity and the restricted party may be acting in concert. The FASB acknowledged that the evaluation of these types of situations would be heavily dependent on particular facts and circumstances and that judgment would be required to assess the substance behind the approval rights contained in a particular agreement.

Whether or not transfer restrictions create a de facto agency relationship under the VIE model is dependent mainly on two factors: (1) whether the “restricted” party has the ability to realize (or manage) its economic interest in the entity and (2) the reasons and economic rationale behind the restrictions placed on that party. The FASB believes that a party possesses the ability to manage its economic interest if the party has the right to sell, transfer, or encumber its interest in that entity without prior approval. If a party has any of these rights, a de facto agency relationship would not exist. For example, if a party has the right to sell its interest without prior approval but must obtain such approval to transfer or encumber that interest, and it is feasible that such party has the ability to realize its economics through a sale, no de facto agency relationship would exist.

As mentioned previously, mutual transfer restrictions do not cause a de facto agency relationship if the parties have the right of prior approval and the rights are based on mutually agreed terms by willing, independent parties. This exception to the de facto agency concept for transfer restrictions may prove helpful for many joint venture arrangements that are determined to be VIEs. Many joint ventures include mutual transfer restrictions. Without providing relief in situations when there are mutual transfer restrictions, even if the joint venture partners are determined to have shared power, one of the parties would have been required to consolidate the entity. This result seemed to be inconsistent with the notion that no party should consolidate if there is shared power. As a result, the FASB provided an exception from the definition of de facto agency relationships for mutual transfer restrictions.

Regarding the economic rationale behind the transfer restrictions, if the approval rights over the sale of the interest are merely to prevent the party from selling its interest to a competitor or to a less creditworthy (or otherwise less qualified) holder and there are a sufficient number of non-competitive

or creditworthy buyers, the restriction would not necessarily create a de facto agency relationship. For example, a franchise agreement between the franchisee and the franchisor gives the franchisor the right to approve the sale of the franchise. If the contractual transfer restriction only prevents the sale of the franchise to a less-than-creditworthy buyer, it would normally not create a de facto agency relationship, provided there are sufficient creditworthy, potential buyers of the franchise. In practice, the economic rationale of the approval rights or transfer restrictions may not always be evident, and considerable judgment will be needed.

Care should also be taken when evaluating whether a restricted party has the means to realize the economics associated with its interest in the entity. If a restricted party only has the right to encumber (pledge) its interest in the entity without prior approval, but the characteristics of the interest do not allow the restricted party to monetize a substantial portion of the interest's fair value (say, below 80%) through that right, it would be difficult to conclude that the restricted party has the ability to realize the economics of its interest.

If the restricted party has the ability to obtain all or most of the cash flows associated with its interest in the entity without prior approval, there is no substantive transfer restriction for purposes of this analysis.

Preparers should consider involving legal counsel, as well as the appropriate level of company management, when assessing the “design” of these restrictions.

Rights of first refusal

A right of first refusal exists in many arrangements and requires a variable interest holder to provide notice to another variable interest holder setting forth the price and payment terms for which a transferred interest is proposed to be sold. The non-transferring variable interest holder would have the right and option to purchase the transferring variable interest holders' interest at the same price. We believe that a right of first refusal generally does not create a de facto agency relationship because the variable interest holder is not constrained from managing its economic interest in the entity.

Rights of first offer

A right of first offer requires a variable interest holder to first offer to transfer its interest to another variable interest holder prior to selling it to a third party. Under these circumstances, the holder of the right of first offer would have the ability to bid to purchase the seller's interest. The seller can decide to accept or reject such bid; however, it cannot sell its interest to another party at a price lower than the price bid by the holder of the right of first offer. The right of first offer may provide some constraint over the seller's ability to sell its interest to a party of its own choosing. However, we believe that a right of first offer provision does not create a de facto agency relationship among parties because the seller is not constrained from managing its economic interest in the entity.

Approval that cannot be unreasonably withheld

A party may have an agreement that it cannot sell, transfer, or convey its interest in the entity without the prior approval of the reporting entity, and such approval cannot be unreasonably withheld. At issue is whether such a clause would result in a de facto agency relationship. As with any other transfer restriction, we believe there is a rebuttable presumption that such provisions create a de facto agency relationship. A reporting entity can overcome that presumption if (1) it can conclude that the approval right would not prevent the restricted party from selling its interest to a qualified or other third party

(specifically considering the reasons for which approval can be withheld) and (2) there are a sufficient number of such qualified buyers to provide a non-restricted market. Oftentimes, the assistance of legal counsel is necessary to interpret the “unreasonably withheld” provision of the agreement and support the entity’s conclusion.

Lock-up periods

In certain agreements, the variable interest holders in an entity may be precluded from selling, transferring, or pledging its interest for a particular time period. For example, consider a fact pattern in which Party A and Party B each own 50% of the equity in Entity X. Party A and Party B have entered into an arrangement whereby during the first 5 years, Party B is precluded from selling, transferring, or encumbering its interest in the entity. In this fact pattern, Party B is a de facto agent of Party A because there is an unconditional contractual restriction on Party B from selling, transferring, or pledging its interest. Once the lock-up period expires, Party B would no longer be considered a de facto agent, which might result in a change in the primary beneficiary conclusion. Evaluating lock-up periods requires considerable judgment.

5.4.2 Related parties—close business relationships

Determining whether a service provider is acting as a de facto agent of a reporting entity can be difficult and will depend on the facts and circumstances present in each situation. This provision is necessary to prevent reporting entities from avoiding consolidation by “parking” interests with a service provider, such as a lawyer or investment bank.

In the past, reporting entities often worked with financial intermediaries (e.g., investment banks) to create financing vehicles that were accounted for as “off balance sheet” structures. The intermediary (or an affiliate thereof) might have decision-making abilities related to that entity through its service contract. We believe that the FASB’s conclusion that close business relationships may create de facto agency relationships was intended to prevent situations in which a portion of a reporting entity’s variable interest could contractually be transferred from a reporting entity to a financial advisor, law firm, or other service provider, in an attempt to avoid consolidation. Reporting entities evaluating these relationships should consider the following factors (which are not meant to be all inclusive):

- Was the service provider involved with the formation of the entity?
- Is the service provider acting as an intermediary between the reporting entity and the entity?
- Is there a “round-trip” transaction of funds through the service provider?

5.5 Primary beneficiary—losses/benefits criterion

If a reporting entity has met the power criterion, it will need to determine whether it has the obligation to absorb losses or the right to receive benefits from the VIE that could potentially be significant to the VIE. A reporting entity must meet both the power criterion and the losses/benefits criterion to be the primary beneficiary of the VIE.

5.5.1 Losses/benefits criterion—qualitative analysis

Determining whether a reporting entity has the obligation to absorb losses of or the right to receive benefits from the VIE that could be potentially significant to the VIE does not have to be based on a

quantitative expected loss/expected residual return calculation. Rather, this assessment is intended to be a qualitative judgment that considers all facts and circumstances, including the terms and characteristics of the variable interest(s), the purpose and design of the VIE, and other involvement that the reporting entity may have with the VIE.

This qualitative analysis should consider all variable interests held by the reporting entity and other variable interest holders that are involved with the VIE. If the reporting entity has other forms of involvement with the VIE that are not variable interests, those relationships should be ignored when assessing the losses/benefits criterion.

5.5.2 *Losses/benefits criterion—potential to be significant*

All scenarios, irrespective of probability, should be considered in assessing whether the right to receive benefits or the obligation to absorb losses could be potentially significant to the VIE. Even when a reporting entity concludes that it is remote that it will be exposed to benefits or losses that could potentially be significant to the VIE, it would meet the losses/benefits criterion given the requirement to consider all possible scenarios.

Although a reporting entity may not have obligations or rights that are currently significant, its variable interest may provide it with obligations or rights that may become significant to the VIE in the future even under seemingly improbable scenarios. These considerations are critical because obligations or rights that could potentially be significant often identify the reporting entity that explicitly or implicitly has the power to direct the activities that most significantly impact the economic performance of the VIE.

5.5.3 *Losses/benefits criterion—significance*

Over time, the FASB has received requests for additional guidance on the losses/benefit criterion, specifically in interpreting “potentially significant to the VIE.” The FASB continues to reaffirm its decision not to provide additional guidance for fear such guidance would provide “bright lines” that would be used inappropriately in practice as the sole factor when determining whether obligations or rights could potentially be significant to the VIE. Determining whether the losses/benefits of a VIE that are absorbed/received by a reporting entity could potentially be significant to a VIE can be judgmental and should be based on the individual facts and circumstances presented.

Examples illustrating the factors that should be considered when identifying the party that is the primary beneficiary are discussed in ASC 810-10-55. These examples do not explicitly state how a reporting entity should determine whether it has the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. The guidance provided does, however, confirm that all variable interests should be considered when making this determination.

We have observed reporting entities develop policies regarding how to assess when an economic interest in a VIE is potentially significant. Some reporting entities have established a policy that ownership of an interest that could potentially expose a variable interest holder to benefits and losses of 5% or less is not significant. When the variable interest(s) being evaluated potentially expose the holder to benefits and losses between 5% and 10%, we believe this could potentially be significant depending on facts and circumstances. In circumstances when a variable interest exposes the holder to 10% or more of a VIE’s potential benefits and losses, we have observed very few instances when the reporting entity concluded such interests were not potentially significant.

When assessing whether a decision maker or service provider’s fee is a variable interest, a reporting entity must consider the significance of its other economic interests (including indirect interests). If the decision maker’s other economic interests are *more than insignificant*, its decision maker or service provider fee is a variable interest. However, the threshold for significance differs when a decision maker is assessing whether they are the primary beneficiary of a VIE. A decision maker is the primary beneficiary of a VIE if its economic interest is *potentially significant*. Because the concept of “more than insignificant” allows for consideration of probability and the concept of “potentially significant” does not, a more than insignificant interest will always be potentially significant since it is a lower threshold.

The following factors may be helpful when qualitatively assessing whether a variable interest is potentially significant:

- The overall purpose and design of the VIE, including the risks and rewards the VIE was designed to create and pass along to its variable interest holders. For example, the primary risks and sources of the VIE’s variability should be considered.
- The terms of the VIE’s interests and capitalization structure, including the risks absorbed and the rewards received by each variable interest holder. For example, it is more likely that a variable interest holder’s right to benefits would be considered significant if the rights have unlimited “upside” (e.g., through a residual interest in the entity). These rights may not be significant in the case of a senior interest that earns a fixed return and has no right to participate in the entity’s earnings beyond that fixed return. It’s important to note that every type of interest of a VIE, including a senior interest, could be potentially significant, depending on the terms of the interest and the purpose and design of the VIE.
- The percentage of the class of interest held by the reporting entity. As the reporting entity’s ownership of a class of interests issued by a VIE increases, it becomes more likely that its variable interest is potentially significant. The reporting entity should also consider whether it holds a “vertical slice” or a “horizontal slice” of the financing or capital structure of the VIE. For example, consider a VIE with two classes of equity, common stock and preferred stock. If a reporting entity owned only a portion of the preferred stock it would be deemed to have a horizontal slice of the capital structure. On the other hand, if the reporting entity owned identical portions of both the common and the preferred stock it would be deemed to own a vertical slice of the capital structure.
- In some cases, a variable interest holder may own a 100% equity interest in a VIE, but that equity interest may be small in comparison to the VIE’s overall capitalization. While that investor’s exposure to losses may be limited to the amount invested, it has the ability to receive benefits from its equity investment that could potentially be significant to the VIE.

5.5.4 Decision maker or service provider fee arrangements

If a decision maker or service provider’s fee arrangement qualifies as a variable interest, its fees may be excluded from the losses/benefits criterion if the arrangement is considered to be “at market” and “commensurate” in accordance with ASC 810-10-25-38H.

ASC 810-10-25-38H

For purposes of evaluating the characteristic in paragraph 810-10-25-38A(b), fees paid to a reporting entity (other than those included in arrangements that expose a reporting entity to risk of loss as described in paragraph 810-10-25-38J) that meet both of the following conditions shall be excluded:

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

As discussed in CG 3.4.1, a reporting entity may consider the following factors, among other items, to determine if the fee arrangement is “at market” and “commensurate”:

- Whether the VIE is owned by substantive third-party investors
- Whether the decision maker holds other variable interests (beyond its fee arrangement) that are unique as compared to variable interests held by the VIE's other investors

After considering these factors, a reporting entity may be unable to qualitatively conclude that the arrangement is at market and commensurate. As a result, additional analysis may be necessary. ASC 810-10-25-38I indicates that a reporting entity should compare the arrangement being evaluated to similar arrangements between third parties. This comparison may not be possible if (1) the fee arrangement relates to a unique or new service (i.e., no comparable arrangements could be identified), or (2) the fee reflects a change in what is considered customary.

As described in ASC 810-10-25-38J, when the arrangement is designed to expose the decision maker to a principal risk of loss, the arrangement would not be eligible for exclusion from the losses/benefits criterion. The following list, which is not intended to be all inclusive, provides examples of fee arrangements that are prohibited from qualifying for this exclusion:

- Fee arrangements where a portion of the fee relates to guarantees of the value of the VIE's assets or liabilities that the decision maker has provided
- Obligations to fund operating losses
- Payments associated with written put options on the VIE's assets
- Similar obligations, such as some liquidity commitments or agreements (explicit or implicit) to protect holders of other variable interests from suffering the VIE's losses.

5.6 Indirect interests held through related parties

A reporting entity that meets the power test should consider its direct interests in the VIE together with its indirect interests in the VIE held through its related parties when determining whether it meets the losses/benefits criterion on a stand-alone basis.

Excerpt from ASC 810-10-25-42

Single Decision Maker – The assessment in this paragraph shall be applied only by a single reporting entity that meets the characteristic in paragraph 810-10-25-38A(a). For purposes of determining whether that single reporting entity, which is a single decision maker, is the primary beneficiary of a VIE, the single decision maker shall include all of its direct variable interests in the entity, and, on a

proportionate basis, its indirect variable interests in the entity held through related parties (the term *related parties* in this paragraph refers to all parties as defined in paragraph 810-10-25-43).

A single decision maker will have an indirect interest in a VIE only when that single decision maker holds a direct variable interest in a related party that in turn holds a variable interest in the VIE (i.e., a variable interest *through* its related party).

If a single decision maker has an indirect interest in a VIE through a related party, its indirect interest should be calculated based on its proportionate share of its related party's variable interest. This analysis can be complex when the interests held by the decision maker and/or its related parties are other than "plain-vanilla" common equity. In some instances, a reporting entity may be required to perform a quantitative analysis to derive its proportionate indirect interest if it is unable to qualitatively conclude whether its total economic interest (direct and indirect) is potentially significant.

Related parties to be considered in this assessment include those defined in ASC 850, *Related Party Disclosures*, as well as parties deemed to be "de facto agents" under the VIE guidance (ASC 810-10-25-43), as discussed in CG 5.4. Unlike the analysis required when evaluating whether a decision-making fee arrangement is a variable interest, indirect interests held by employees and employee benefit plans should be included in the indirect interest assessment.

Example CG 5-12 illustrates the evaluation of whether a single decision maker has an indirect interest when determining the primary beneficiary of a VIE.

EXAMPLE CG 5-12

Evaluating whether a single decision maker has an indirect interest when determining the primary beneficiary of a VIE

A GP has a 2% general partner interest in a limited partnership that is a VIE. The GP also has a 40% equity interest in a related party that has a 30% limited partnership interest in the limited partnership. The GP is the single decision maker of the limited partnership.

What is the indirect interest that should be considered in determining the primary beneficiary?

Analysis

Since, in addition to its direct interest in the VIE, the GP has a direct equity interest in a related party which has a direct partnership interest in the VIE, the GP is also deemed to have an indirect interest in the VIE. The GP would have an indirect interest of 12% (40% x 30%) in the VIE for purposes of determining whether it is the primary beneficiary.

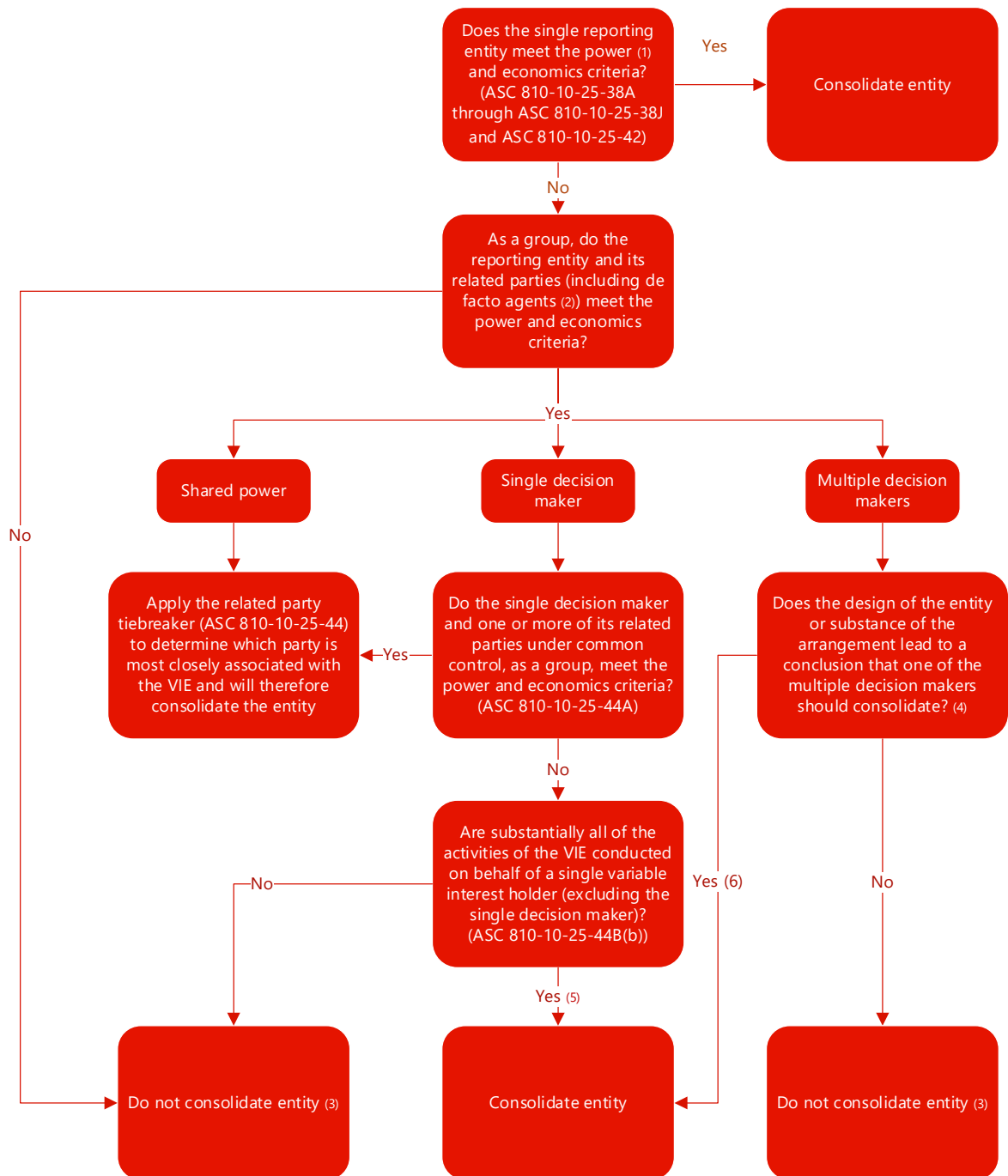
5.7 Related parties—standalone primary beneficiary does not exist

As discussed in CG 5.1, a reporting entity must first determine whether it meets power and losses/benefits criteria on a stand-alone basis. Only if the reporting entity does not meet both criteria on a stand-alone basis should it consider other variable interests held by its related parties to

determine whether it is part of a related party group that collectively meets both characteristics of a primary beneficiary. If this is the case, a reporting entity should assess whether a party within that related party group should consolidate the VIE.

Figure CG 5-2 provides a general overview of the primary beneficiary analysis including related parties.

Figure CG 5-2
 General overview of the primary beneficiary analysis including related parties



(1) Power is defined as the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.

(2) The VIE model expands the definition of related parties, as described in ASC 850, Related Party Disclosures, to include “de facto agents,” which are described in ASC 810-10-25-43 and CG 5.4.

(3) It may be necessary to also evaluate consolidation at a parent level. There may be situations involving “multi-tier structures” in which neither the reporting entity nor other “lower-tier” entities within its related party group meet the criteria to consolidate

the VIE in their standalone financial statements. In these instances, there may be a parent entity that holds power and economics indirectly through its subsidiaries that should therefore consolidate the VIE.

(4) When a controlling party in a related party group designs an entity to separate power from economics for the purpose of avoiding consolidation in the separate company financial statements of a decision-maker, such separation may be nonsubstantive. If the separation of power is nonsubstantive, it should be disregarded. This is consistent with the guidance in ASC 810-10-15-13A that only substantive terms, transactions, and arrangements, whether contractual or noncontractual, should be considered by a reporting entity when evaluating whether it has a controlling financial interest.

(5) The entity on whose behalf substantially all of the activities of the VIE are conducted would consolidate the VIE.

(6) The reporting entity identified in Footnote 4 would consolidate.

5.7.1 *Shared power among related parties*

In certain situations, the power to direct a VIE's most significant activities may be shared among related parties. In those situations, the related party tiebreaker should be applied to determine which party within the related party group is required to consolidate the VIE.

Excerpt from 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 the preceding 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.

In situations where power over an entity's most significant activities is shared among related parties, a qualitative analysis is required to determine which party within the related party group is most closely associated with the VIE. The party within the related party group that is most closely associated with the VIE is the primary beneficiary and is required to consolidate and disclose the impact of the VIE. Refer to CG 5.8 for further discussion related to the application of the related party tiebreaker test.

If no single party within the related party group has stated power, and a VIE's significant activities require the consent of two or more related parties, a reporting entity must assess whether power is shared. As discussed in CG 5.2.4, shared power exists only when the unanimous consent of all parties believed to share power over a VIE's economically significant activities is required. This concept is illustrated in Example CG 5-13.

EXAMPLE CG 5-13

Shared power among related parties – equal equity ownership

ABC Co., DEF Co., and XYZ Co., all related parties, each hold a variable interest in Oak Co., a VIE and manufacturer of oak furniture for wholesale distribution to retail furniture stores. Each party holds 33% of Oak Co.'s equity and obtained its equity interests in exchange for contributions of cash upon formation of Oak Co. All profits and losses of Oak Co. are allocated to the equity investors pro rata in accordance with their equity interests. Apart from their equity interests, neither party holds any other variable interests in Oak Co.

The board of directors is comprised of six directors—two each appointed by ABC Co., DEF Co., and XYZ Co. All decisions related to Oak Co.'s significant activities require approval by a two-thirds majority vote of the board of directors (i.e., four of the six directors). Without the ability to exercise

two-thirds of Oak Co.'s voting rights, no single equity investor has the power to direct Oak Co.'s activities that most significantly impact its economic performance.

Oak Co. has determined that the activities that most significantly impact Oak Co.'s economic performance are:

- Purchasing raw materials
- Manufacturing
- Sales of oak furniture

Is the power to direct Oak Co.'s most significant activities shared among ABC Co., DEF Co., and XYZ Co.?

Analysis

No, power over Oak Co. is not shared because the decisions related to Oak Co.'s most significant activities do not require the *unanimous* consent of all equity investors, acting through their representation on Oak Co.'s board of directors. For power to be shared, the significant activities would require the approval of all equity investors. Even though the three equity investors are related and as a group would meet the characteristics of a primary beneficiary, the related party tiebreaker test would not be applied since power is not shared and the three equity investors are not under common control. We believe a reporting entity should consider the substance of the voting rights and the nature of the related party relationships before concluding that there is no primary beneficiary.

5.7.2 Common control groups—characteristics of a primary beneficiary

If the related party group has both characteristics of a primary beneficiary and is under common control, then the “related party tiebreaker” test should be performed to identify the variable interest holder within that related party group that is “most closely associated” with the VIE. The party that is most closely associated with the VIE should consolidate the VIE.

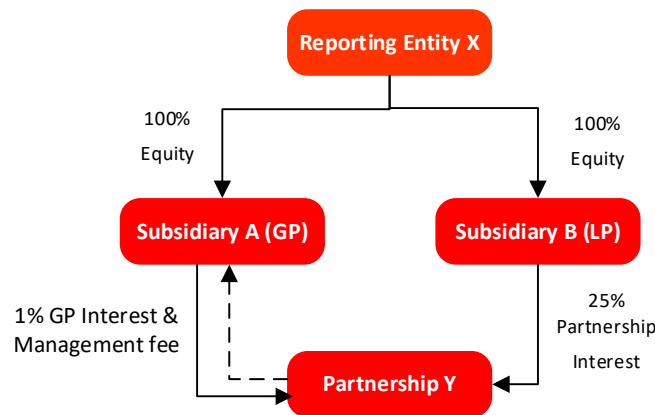
The term “common control” is not defined within U.S. GAAP. ASU 2015-02's basis for conclusions indicates that the FASB's intent was for subsidiaries controlled (directly or indirectly) by a common parent, as well as a subsidiary and its parent, to be considered a common control group. When determining whether a related party group is under common control, we believe a parent entity should have a controlling financial interest over the related parties involved. A controlling financial interest is generally defined as ownership of a majority voting interest by one entity, directly or indirectly, or more than 50% of the outstanding voting shares of another entity, with certain exceptions. A controlling financial interest would also exist if the parent entity consolidates its subsidiaries based on the provisions in the VIE model. Refer to BCG 7 for further discussion related to common control transactions.

We do not believe the parent entity must be a legal entity for a common control group to exist. That is, a parent could be a natural person that holds a controlling financial interest in various entities.

Example CG 5-14 illustrates the determination of whether a commonly controlled related party group meets both characteristics of a primary beneficiary.

EXAMPLE CG 5-14**Determining whether a commonly controlled related party group meets both characteristics of a primary beneficiary**

Subsidiary A and Subsidiary B are under common control of their parent, Reporting Entity X. Subsidiary A is the general partner and decision maker of Partnership Y, whereby it owns a 1% general partner interest and receives a management fee that is considered at market and commensurate. Subsidiary A does not hold any other interest in the partnership. Subsidiary B has 25% of the partnership's limited partner interests. The other limited partner interests are held by unrelated parties. Neither Subsidiary A nor Subsidiary B has an interest in each other. As the limited partners do not have substantive kick-out or participating rights over the general partner, the Partnership is determined to be a VIE.



Does the commonly controlled related party group meet both characteristics of a primary beneficiary?

*Analysis**Subsidiary analysis*

No. Subsidiary A's 1% general partner interest would not be considered more than insignificant and the management fee is at market and commensurate. Therefore, Subsidiary A does not have a variable interest in Partnership Y (unless it was determined that the partnership was structured to separate power and economics in an attempt to avoid consolidation). As a result, Subsidiary A is considered to be operating in an agency capacity and does not meet the power criterion. While Subsidiary B's 25% limited partner interest is a potentially significant economic interest that would allow it to meet the losses/benefits criterion, neither subsidiary meets both criteria of a primary beneficiary on a stand-alone basis.

As Subsidiary A is acting in an agent capacity (i.e., it is not considered a decision maker), the related party group under common control would not meet the criteria in ASC 810-10-25-44A in order to apply the related party tiebreaker test.

Further, unless "substantially all" of the partnership's activities involve or are conducted on behalf of Subsidiary B, Subsidiary B would also not be required to consolidate the partnership under ASC 810-10-25-44B.

While Subsidiary A’s decision-making fee is not considered a variable interest for the purposes of assessing whether Subsidiary A is the primary beneficiary, it still holds a variable interest in Partnership Y through its 1% general partner interest, and therefore both Subsidiary A and Subsidiary B should consider if they are required to make necessary VIE disclosures. See FSP 18 for discussion on disclosures.

Parent analysis

Reporting Entity X, as a parent, meets both the power criterion (through Subsidiary A) and the losses/benefits criterion (through Subsidiary B), and therefore would be the primary beneficiary of Partnership Y and would consolidate Partnership Y in its consolidated financial statements.

5.7.3 Related parties not under common control

If a single decision maker within a related party group has unilateral power, and the related party group is not under common control, then the related party tiebreaker would not apply. However, if “substantially all” of the VIE’s activities involve or are conducted on behalf of any party (excluding the single decision maker) within that related party group that meets both characteristics of a primary beneficiary, the party that has the activities conducted on its behalf is required to consolidate the VIE. This requirement is intended to prevent abuse (i.e., “vote parking” arrangements) where the decision maker’s level of economics is not consistent with its stated power.

This assessment, which is intended to be consistent with the analysis required to determine whether an entity is a VIE (refer to CG 4), should be qualitative and consider all relevant facts and circumstances.

Example CG 5-15 illustrates the application of the “substantially all” related party test.

EXAMPLE CG 5-15

Application of the “substantially all” related party test

Company A, Company B, and Company C formed a venture (Company X) that was determined to be a VIE. Company X’s outstanding equity interests are owned as follows:

- Company A – 5%
- Company B – 45%
- Company C – 50%

Each party participates in Company X’s profits and losses on a pro rata basis.

Company B financed Company A’s investment in Company X, therefore, Company A and Company B were determined to be related parties in accordance with the de facto agency guidance in ASC 810-10-25-43(b).

Company A, through super-voting shares, has the ability to unilaterally direct the activities that most significantly impact Company X’s performance. Neither Company B nor Company C have substantive

participating rights, therefore, Company A meets the power criterion. Company A does not receive a decision-making fee, therefore, the ASC 810-10-55-37 agency test would not be applicable.

Which party should consolidate the VIE?

Analysis

Although Company A has power, it does not meet the losses/benefits criterion since it is not exposed to losses and/or benefits that could potentially be significant to the VIE. Therefore, Company A is not Company X's stand-alone primary beneficiary. A related party group consisting of Company A (a single decision maker) and Company B (a variable interest holder with a potentially significant economic interest) does exist. Because the related party group is not under common control, the related party tiebreaker would not be applicable. However, an analysis should be performed to determine whether substantially all of Company X's activities are conducted on Company B's behalf. If that were the case, Company B would be Company X's stand-alone primary beneficiary.

5.7.4 Related parties—multiple decision makers

If there are multiple decision makers in a related party group, we believe a reporting entity should consider the purpose and design of the entity, and substance of the arrangement (including the substance of voting rights or other rights held by each party) to determine whether it would be appropriate for one of the variable interest holders within the related party group to consolidate the VIE.

5.8 Related party tiebreaker

ASC 810-10-25-44

The guidance in this paragraph shall be applicable for situations in which the conditions in paragraph 810-10-25-44A have been met or when power is shared for a VIE. In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph 810-10-25-38A but, as a group, the reporting entity and its related parties (including the de facto agents described in paragraph 810-10-25-43) have those characteristics, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and shall be based on an analysis of all relevant facts and circumstances, including all of the following:

- a. The existence of a principal-agency relationship between parties within the related party group
- b. The relationship and significance of the activities of the VIE to the various parties within the related party group
- c. A party's exposure to the variability associated with the anticipated economic performance of the VIE
- d. The design of the VIE.

5.8.1 *When to apply the related party tiebreaker*

Related parties and de facto agency relationships can play a critical role in (1) the determination of whether the entity is a VIE, and (2) the determination of the VIE's primary beneficiary, if one exists.

Generally, the related party tiebreaker would apply when the related party group, rather than a single party within the group, meets the power and losses/benefits criteria and one of the following situations applies:

- Power is shared among the related party group (i.e., no party within the related party group individually meets the power and losses/benefits criteria, but the related party group collectively meets both characteristics of a primary beneficiary).
- One of the parties in the related party group meets the power criterion on a stand-alone basis but not the losses/benefits criterion. However, the related party group is under common control and collectively meets the losses/benefits criterion.

In situations where the related party tiebreaker is applied, the identification of the party within the related party group that is most closely associated to the VIE is required. This analysis should be based on the facts and circumstances specific to the VIE being assessed for consolidation.

Question CG 5-5

If one party within a related party group meets both criteria to be the primary beneficiary, but another party within that group receives the majority of the economics, should the related party tiebreaker be applied?

PwC response

No, the related party tiebreaker should not be applied in this scenario. If one party in the related party group meets both the power and benefits/losses criteria, then that party is the primary beneficiary. If a single party with a majority of the economics lacks stated power, the power criterion should be carefully analyzed to ensure that single party does not have some form of implied power. Refer to CG 5.2.9 for further information on implied power.

5.8.2 *Applying the related party tiebreaker*

In circumstances where the related party tiebreaker must be applied, judgment is required. Factors to consider in making the assessment include:

- The four key indicators described in the VIE model, and
- The relative weighting of these indicators based on the individual facts and circumstances of each transaction and structure.

The four key factors are explained in more detail below.

5.8.2.1 *Related party tiebreaker—principal/agency relationship*

The first indicator for identifying the primary beneficiary from the related party group is the existence of an agency relationship among the parties. If one member of the group was acting in the capacity of an agent for another member of the related party group, this would be a strong indicator that the

principal would be the primary beneficiary. This type of relationship can take many forms, including de facto agency relationships defined in the VIE model. Additionally, there may be situations beyond those included in the VIE model in which an agency relationship may exist among members of the related party group.

When evaluating whether an agency relationship exists among members of the related party group, it may be helpful to analogize to other accounting guidance relating to principal-agency relationships. ASC 470-50, *Debt—Modifications and Extinguishments*, describes the appropriate accounting for modification of debt instruments and lists several indicators that may be useful in determining when a third-party intermediary is acting as an agent on behalf of a debtor. ASC 606, *Revenue Recognition—Principal Agent Considerations*, describes the appropriate revenue recognition in transactions depending on whether the reporting entity is acting as an agent or a principal. The existence of any indicators listed under Gross Revenue Reporting in ASC 606 may indicate that the reporting entity is acting as a principal. The existence of any indicators listed under Net Revenue Reporting in ASC 606 may indicate that the reporting entity is acting as an agent.

5.8.2.2 Related party tiebreaker—relationship and significance

The second indicator for identifying the primary beneficiary in the related party group considers the relationship of the VIE to each of the members within the related party group, as well as the significance of the VIE's activities to those members. The member of the related party group that this indicator points toward may depend upon the point of view of the reporting entity carrying out the evaluation. For example, two members of a related party group may come to different conclusions when evaluating this indicator, as they may each have an inherent bias when evaluating their relationship with the VIE.

The evaluation of the significance of the VIE's activities should be based on all the relationships between the VIE and the various members of the related party group. The focus of this analysis should not be limited to the size of the VIE in relation to the size of the members of the related party group. It should not be presumed that the activities of the VIE are more significant to a smaller party than a larger one, merely because one entity is smaller than the other. Rather, other factors should be considered, for example:

- Whether one party is significantly dependent upon the VIE as a supply/distribution source;
- Whether one party is the lessee of the VIE's only asset;
- Whether the reporting entity funds research and development of the VIE that is integral to that party's underlying operations;
- The nature of the VIE's business activities, and whether they are inherently aligned with one of the parties within the related party group;
- The significance of the VIE's sales of product (or output) to one of the parties within the related party group;
- Understanding the nature of service contracts, management contracts, or other contracts entered into by the VIE with a related party, and the importance of that related party to the underlying business activities of the VIE;

- Whether any member within the related party group has a call option to acquire significant or major assets from the VIE, or another related party's variable interest; and
- Whether any related party has an option to put its variable interest to another member within the related party group.

When evaluating this indicator, a reporting entity may also look to the indicators provided in CG 4.4.

5.8.2.3 *Related party tiebreaker—variability associated with economics*

The third indicator for identifying the primary beneficiary within a related party group focuses on exposure to the VIE's economic performance. When analyzing this indicator, each variable interest holder's potential to receive benefits or absorb losses of the VIE based on changes in the entity's anticipated economic performance should be considered. Note that this analysis takes into account the member's obligations and rights throughout the life cycle of the VIE and considers the extent to which the member's expected rights to receive benefits and obligation to absorb losses change based on variations of the anticipated economic results of the VIE.

If a decision maker receives a fee arrangement that is at market and commensurate, we do not believe the decision maker's exposure to the VIE's expected risks and rewards can be disregarded for purposes of this criterion. Although at market and commensurate fees are excluded in the variable interest and primary beneficiary determinations, we do not believe it would be appropriate to disregard such fees when determining which party within a related party group should consolidate a VIE, particularly when considering that the FASB did not amend the related party tiebreaker guidance.

There may be situations in which one member of the group is exposed to such a large portion of the variability associated with the VIE's anticipated economic performance that it would be difficult not to conclude that the party is the primary beneficiary. However, each of the four factors should be considered. If a reporting entity is acting on behalf of another reporting entity in a fiduciary capacity (i.e., as an agent), the reporting entities should understand why the arrangement exists and use reasoned judgment to determine which party this characteristic indicates is most closely associated to the VIE.

In determining how much weight to place on this indicator, we believe that the nature of the related party relationship should be considered. If, for example, the related party relationship is that of a parent company and its wholly owned subsidiary, the contractual allocation of incremental benefits and losses generated through variability from the VIE's expected performance is of little importance, and therefore little weight should be placed on this indicator. However, if the relationship is that of two independent variable interest holders investing in a joint venture where one of the companies cannot sell or transfer its interest without the other's prior approval (i.e., they are related parties through a de facto agency relationship), more significant weight may be placed on this indicator. Varying degrees of weighting should be applied between those two extremes.

5.8.2.4 *Related party tiebreaker—design of the VIE*

The fourth indicator for identifying the primary beneficiary from the related party group focuses on the design of the VIE. When evaluating this indicator, reporting entities should focus on the structure of the VIE to identify the appropriate primary beneficiary. There may be instances where an entity was designed or structured for the benefit of one member within the related party group. Examples of these types of relationships may include:

- A VIE was established for the securitization of certain assets and the transferor of those assets.
- A VIE was established to own and lease a single asset to a lessee; and
- A VIE was established to provide off-balance sheet financing to the beneficiary of that financing.

Again, this indicator requires the use of professional judgment, and certain structures/transactions will be more obvious than others.

5.9 Ongoing reassessment of the primary beneficiary

If an entity is a VIE, ASC 810-10 requires the primary beneficiary analysis to be performed at formation (or when a reporting entity initially becomes involved with the VIE), and at each subsequent reporting date. Changes in facts and circumstances occurring since the previous primary beneficiary determination should be considered as part of this ongoing assessment.

In establishing this requirement, the FASB noted that the requirement for reporting entities to continuously reassess whether they are the primary beneficiary of a VIE would provide benefits to the financial statement users that outweigh the anticipated costs to comply with the requirement. For example, if a reporting entity has a variable interest in a VIE in the form of a guarantee, and over time the VIE's performance declines significantly, then the guarantor may become the primary beneficiary. This ongoing assessment is intended to be performed qualitatively.

When a reporting entity identifies a change in the primary beneficiary of a VIE, it should recognize the effects as of the date when the change occurred.

Because the primary beneficiary of a VIE must be reassessed on an ongoing basis, the determination of related parties (and de facto agents) must also be continuously reassessed.

***Chapter 6:
Initial consolidation of a
VIE—updated December
2022***

6.1 Initial consolidation

When a reporting entity obtains control of a legal entity, it must determine if the net assets within the legal entity constitute a business. To the extent it is a business, acquisition accounting procedures under ASC 805 would be applied irrespective of whether control is gained under the VIE or voting interest entity model. Therefore, the initial consolidation of a VIE that is a business and not received in a common control transaction is treated as a business combination. See BCG 1.2 for the definition of a business and BCG 2 for application of the acquisition method when acquiring a business. Refer to BCG 7 for further information on accounting for common control transactions.

If a reporting entity obtained control of a VIE that is not a business and not in a common control transaction, the primary beneficiary should account for the initial consolidation pursuant to the guidance in ASC 810-10-30. No goodwill is recognized if the variable interest entity is not a business.

ASC 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.

ASC 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

If a reporting entity becomes the primary beneficiary of a VIE that is not a business, it should initially measure and recognize the VIE's assets (except for goodwill) and liabilities in accordance with ASC 805-20-25 and ASC 805-20-30. Consistent with the application of ASC 805 in a business combination, transaction costs are not considered part of the fair value of the identifiable assets and liabilities and should be expensed.

In limited circumstances, a reporting entity that is determined to be the primary beneficiary of a VIE does not have an equity investment in the entity. In these cases, the primary beneficiary must consolidate 100% of the balance sheet and income statement of the VIE and should generally apply

consolidation procedures as if it were the parent in a typical parent-subsidary relationship. These consolidation procedures include applying the acquisition method and reflecting equity interests in the VIE held by other parties as a noncontrolling interest.

When consolidating a VIE, assets and liabilities transferred from the primary beneficiary to the VIE at, after, or shortly before the date the reporting entity became the primary beneficiary must be accounted for in accordance with ASC 810-10-30-3.

As an overriding principle, assets or liabilities transferred from a reporting entity to a VIE should not be remeasured if the reporting entity is the primary beneficiary. These transactions are viewed similar to transactions between entities under common control.

The assets and liabilities transferred should be measured at the amounts at which the assets and liabilities would have been measured if they had not been transferred. No gain or loss should be recognized because of the transfer, even if the reporting entity was not the primary beneficiary until shortly after the transfer.

6.1.1 *Measuring the financial assets and liabilities of a consolidated collateralized financing entity*

ASC 810-10-15-17D provides an alternative for measuring the financial assets and financial liabilities of a collateralized financing entity that is consolidated by a reporting entity. The ASC Master Glossary provides the following definition of a collateralized financing entity.

Definition from ASC Master Glossary

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).

When a reporting entity elects the fair value option, financial assets and financial liabilities of the entity must be measured separately at their fair values. As a result, the aggregate fair value of the financial assets may differ from the aggregate fair value of the financial liabilities. The guidance allows the use of the more observable of the fair value of the financial assets or the fair value of the financial liabilities of the collateralized financing entity to measure both. As a result, this alternative would eliminate the measurement difference that may exist when the financial assets and financial liabilities are measured independently at fair value.

If the measurement alternative is not elected, reporting entities will have to reflect any measurement differences between the collateralized financing entity's financial assets and third party financial liabilities in earnings and attribute those earnings to the controlling equity interest in the consolidated income statement.

***Chapter 7:
Voting interest model—
updated July 2023***

7.1 *Voting interest model—chapter overview*

This chapter describes the voting interest entity consolidation models for corporations and limited partnerships. It also describes the consolidation by contract model. The voting interest entity consolidation models for corporations and limited partnerships are not the same. Therefore, entities that are not clearly corporations or limited partnerships, such as limited liability companies and trusts, should determine whether their governing provisions as described in their governing documents make them more like a corporation or a limited partnership in deciding which model to apply.

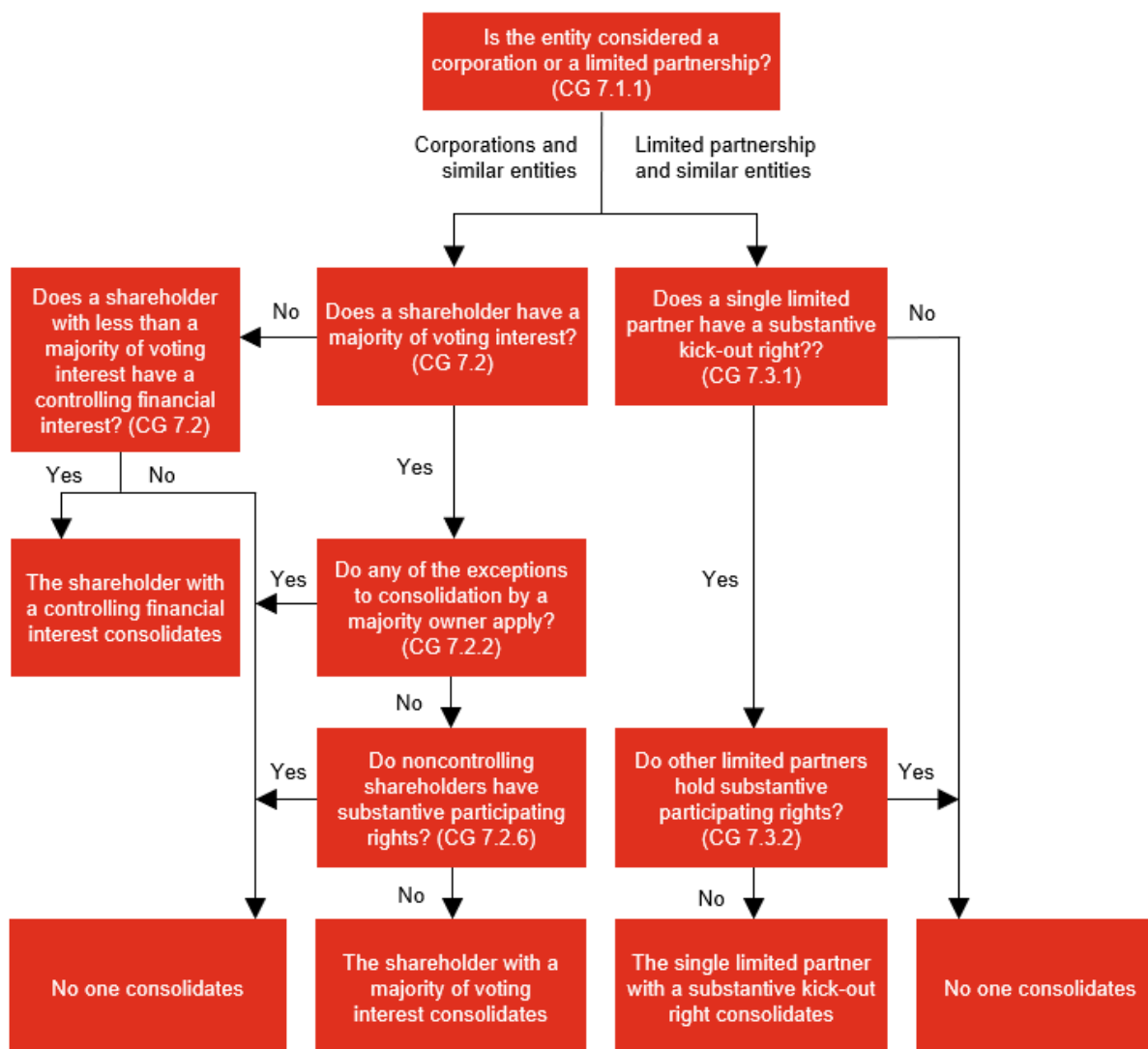
The voting interest entity model (referred to as the “VOE” model) requires the reporting entity to have a controlling financial interest in an entity. A controlling financial interest is generally based on the concept that a reporting entity should have the unilateral right to make the significant financial and operating decisions of an entity without regard to probability.

The voting interest entity model applies to all entities that are not variable interest entities (VIEs). That is, the voting interest model applies after an investor considers whether it has a variable interest in a VIE and determines that the investee is not a VIE. If an entity is not a VIE under ASC 810-10-15-14, the following consolidation guidance under ASC 810 should be considered to determine the appropriate consolidation model depending on the type of entity or arrangement:

- Corporations and similar entities, see CG 7.2
- Limited partnerships (LPs) and similar entities, see CG 7.3
- Entities controlled by contract, see CG 7.4
- Research and development arrangements, see CG 8.3.1

Figure CG 7-1 summarizes the voting interest consolidation model.

Figure CG 7-1
Summarized voting interest consolidation model



To apply the VOE model it is important to understand the type of legal entity being evaluated for consolidation and evaluate the governance of that legal entity to determine whether the reporting entity holds a controlling financial interest in the legal entity.

7.1.1 *Limited liability companies and other similar legal entities*

Certain legal entities such as limited liability companies (LLCs), limited liability partnerships, and others have characteristics of both corporations and partnerships. Therefore, a reporting entity with an interest in a similar legal entity would need to first determine whether the governing provisions of the entity are the functional equivalent of a limited partnership or a corporation.

For example, a reporting entity with an interest in an LLC will need to determine whether the LLC has governing provisions that are the functional equivalent of an LP or a corporation in order to determine whether it has a controlling financial interest in the LLC. A detailed analysis of the LLC's formation

and governing documents should be performed to understand the LLC's governance structure and determine whether it is the functional equivalent of an LP or a corporation.

ASC 810-10-05-3 states that for LLCs with managing and non-managing members, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner. In this case, a reporting entity with an interest in an LLC (which is not a VIE) would likely apply the consolidation model for LPs if the managing member has the right to make the significant operating and financial decisions of the LLC. Alternatively, some LLCs are governed by a board of members which makes all the significant operating and financial decisions. In this case, we believe a reporting entity with an interest in an LLC (which is not a VIE) would follow the consolidation model for majority owned subsidiaries (corporations). In other cases, an LLC has both a managing member and a board of members. A reporting entity would need to assess the rights of both the managing member and board of members to determine who is responsible for making the significant operating and financial decisions of the LLC. In practice we have seen cases including the following:

- The managing member is responsible for making the significant operating and financial decisions while the board of members is responsible for activities that would be deemed protective rights, or
- The significant operating and financial decisions are shared between the managing member and the board of members, or
- The managing member is responsible for day-to-day operations while the board of members is responsible for significant operating and financial decisions of the LLC.

As described above, the reporting entity would need to perform a careful analysis to determine whether the governance of the LLC is the functional equivalent of an LP or a corporation.

The guidance in ASC 323-30-35-3 (dealing with specific ownership accounts for each investor) addresses whether an LLC should be viewed as similar to a corporation or similar to a partnership for purposes of determining whether a noncontrolling investment in an LLC should be accounted for at fair value (or using the measurement alternative) or by using the equity method. While this guidance can be used to help assess whether an entity's governance provisions are the functional equivalent of a corporation or partnership for purposes of assessing whether an investor has a controlling financial interest in an LLC, it should not be the only factor in making that assessment. Refer to EM guide for further discussion about the equity method of accounting.

7.2 *Voting interest model—corporations and similar entities*

Under the ASC 810-10 VOE consolidation model, a reporting entity must consolidate any entity in which it has a controlling financial interest.

Controlling financial interest

For entities that are not VIEs, the usual condition for a controlling financial interest is ownership of over 50% of the outstanding voting shares. Under the provisions of ASC 810-10-15-10(a), all majority-owned subsidiaries (i.e., all companies in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest) must be consolidated unless control does not

rest with the majority owner. See CG 7.2.1 and 7.2.2 for situations where control may not rest with the majority owner.

In some cases, more than a simple majority voting interest may be needed to have a controlling financial interest. For example, an entity may have agreements or bylaws requiring approval from two-thirds of the outstanding voting interests for major decisions, rather than a simple majority. In this case, only a holder of at least two-thirds of the outstanding voting interest would have a controlling financial interest.

For SEC registrants, Regulation S-X 1-02(g) defines “control” as “...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.” While the SEC’s definition of control suggests that control may be achieved with a less than majority ownership of the voting shares, the SEC does not list specific criteria that should be considered in making that assessment. Rather, Regulation S-X 3A-02 emphasizes the need to consider substance over form to establish an appropriate consolidation policy in determining whether a less than majority owned entity should be consolidated.

The provisions of S-X 3A-02 were frequently applied by the SEC staff prior to the introduction of the VIE consolidation model. However, many of the situations previously subject to S-X 3A-02 are now in the scope of the VIE guidance since many of these entities are VIEs. Consequently, S-X 3A-02 is referenced less today, but nonetheless, should be considered in determining an appropriate consolidation policy.

Control without majority of voting rights

In some circumstances, a reporting entity may have a controlling financial interest in another entity (which is not a VIE) without owning a majority voting interest. The accounting for these situations should be determined based on the economic substance of the transaction. See CG 7.2.3 to CG 7.2.6.

7.2.1 *Assessing control through indirect interest (VOE model)*

A reporting entity may control another entity through a combination of both direct and indirect ownership interests held through a controlled intermediate entity. In those cases, it is possible for a reporting entity to have an economic interest of less than 50% of another entity, but still have a controlling financial interest in the entity. Conversely, a reporting entity could have an economic interest of more than 50% of another entity, but lack control because it does not hold a majority voting interest.

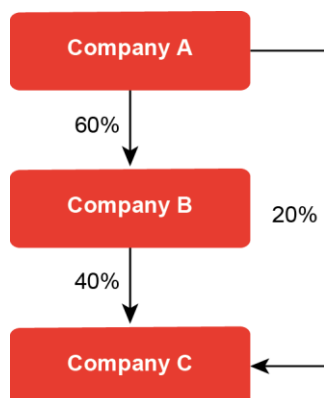
Example CG 7-1 and Example CG 7-2 describe scenarios in which indirect ownership may or may not result in control.

EXAMPLE CG 7-1

Control with less than 50% economic interest

Company A has a controlling financial interest in Company B through its 60% ownership interest in Company B. Company B, in turn, owns 40% of Company C. Company A also directly owns 20% of Company C.

Company B and Company C are voting interest entities and all ownership interests represent voting interests. A majority voting interest of an entity is assumed to result in a controlling financial interest.



Should Company A consolidate Company C?

Analysis

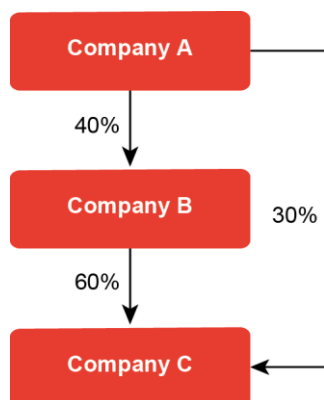
Yes. Even though Company A only has an economic interest of 44% in Company C (i.e., its 20% direct interest, plus its 60% of Company B's 40% direct interest in Company C), Company A does have a controlling financial interest in Company C. Since Company A controls Company B, and thus can control Company B's 40% voting interest in Company C, plus it has a direct 20% voting interest in Company C, Company A has a 60% controlling voting interest in Company C.

EXAMPLE CG 7-2

No control with more than 50% economic interest

Company A owns 40% of Company B. Company B, in turn, has a controlling financial interest in Company C through its 60% ownership interest in Company C. Company A also directly owns 30% of Company C.

Company B and Company C are voting interest entities and all ownership interests represent voting interests. A majority voting interest of an entity is assumed to result in a controlling financial interest.



Should Company A consolidate Company C?

Analysis

No. Even though Company A has an economic interest of 54% in Company C (i.e., its 30% direct interest, plus its 40% of Company B's 60% direct interest in Company C), it does not control Company C. Since Company A does not control Company B, Company A would not be able to combine Company B's 60% interest in Company C with its 30% direct interest in Company C to obtain a controlling financial interest in Company C.

7.2.2 *Exceptions to consolidation by a majority owner (VOE model)*

Under ASC 810-10, all majority-owned subsidiaries (i.e., all entities in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest) must be consolidated, unless control does not rest with the majority owner.

The following are instances where control does not rest with the majority owner:

- The subsidiary is in legal reorganization or in bankruptcy. Refer to BLG for further discussion.
- 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. Evidence of such a lack of control includes a parent's inability to repatriate funds of a subsidiary because of long-term exchange restrictions, political uncertainties, threats of expropriation of a subsidiary's assets, and other similar situations.
- The majority owner's voting rights are restricted by certain approval or veto rights granted to the noncontrolling shareholder, which qualify as substantive participating rights. Refer to CG 7.2.6.
- The parent is a broker-dealer within the scope of ASC 940, *Financial services—brokers and dealers*, and has a controlling financial interest in a subsidiary for which control is likely to be temporary. This exception for when control is likely to be temporary should not be analogized to reporting entities that are not broker/dealers. Refer to ASC 940-810-45-1.

7.2.3 *Potential voting rights, call options, & convertible instruments*

Entities may issue various financial instruments to reporting entities that provide the reporting entities with potential voting rights. For example, entities may issue call options, convertible instruments, and other similar instruments with potential voting rights to reporting entities. Depending on the terms, these instruments, if exercised or converted, may provide the reporting entity with a controlling financial interest in the entity. In these situations, questions may arise as to whether the reporting entity has a controlling financial interest in the entity prior to exercise or conversion of these financial instruments.

Generally, under the voting interest entity model, these types of financial instruments are not included in the determination of whether the reporting entity has a controlling financial interest in the entity as the voting interest entity model is not an effective control model. However, in certain limited circumstances, the terms and conditions of these instruments may make them so highly likely of exercise or conversion that a reporting entity may be deemed to have a controlling financial interest in the entity even though the instruments have not been actually exercised or converted. In making this assessment, a reporting entity should consider all facts and circumstances, including its relationships

with the entity and other investors. Although not all inclusive, the reporting entity should consider the following:

- *Terms of the financial instrument* – is there a high likelihood that the instrument will be exercised or converted? Is the instrument currently exercisable or convertible? Is the exercise or conversion price significantly in the money or a nominal amount? Does the exercise or conversion period span a long period of time? For example, if an option is currently exercisable with a nominal exercise price, the exercise of the option would likely have no significant effect on the investor and, therefore, the investor may have the ability to currently control the entity. On the other hand, an option that is not currently exercisable and at an exercise price that is not substantially in the money would likely indicate that the exercise of the option is substantive and the investor does not have the current ability to control the entity.
- *Relationships with entity and other investors* – is the reporting entity controlling the operational and financial decisions of the entity by virtue of the nature of its relationships with the entity? Is the entity dependent on the reporting entity or vice versa? If so, how critical is that dependency? Does the reporting entity have call or put options with the other investors of the entity?
- *Purpose of the entity* – is the entity being used for research and development activities, start-up activities, or marketing activities? Is the entity expected to incur losses in the early years of operations? If so, is this structure being used to avoid recording losses?

7.2.4 Control of the board of directors

A reporting entity may have a controlling financial interest in a less-than-majority-owned entity when the reporting entity has control of the board of directors, and the significant decisions of the entity are made at the board level. For example, a reporting entity may, without owning a majority of the voting shares, have the ability to appoint or elect the majority of the board of directors. These types of situations may be agreed upon and reflected in an entity's governing documents (articles of incorporation, by-laws, or operating agreements) or by other separate agreements with the shareholders (voting proxies or other contractual arrangements). In making the determination of whether a less-than-majority owner demonstrates a controlling financial interest and should consolidate, the reporting entity should ensure that 1) the significant decisions of the entity are made at the board of directors level, 2) any matters voted upon at the shareholder level are not considered significant decisions, 3) other shareholders or other parties are not able to change the composition of the board of the directors, and 4) the ability to appoint a majority of the board of directors is for a substantial period of time.

In addition, the conditions providing a less-than-majority owner with control of the board may require further consideration of whether the entity is a voting interest entity or a VIE. See CG 4 for guidance on determining whether an entity is a VIE.

Example CG 7-3 and Example CG 7-4 provide additional guidance and factors to consider when assessing whether a less-than-majority-owned entity should be consolidated because of control of the board of directors.

EXAMPLE CG 7-3

Evaluating whether a controlling financial interest exists when one investor has the ability to appoint the majority of the board of directors

Company A and several private equity investors establish Company X. Company A owns 49% of the voting stock of Company X. None of the private equity investors own more than 15% of the voting stock. Through the articles of incorporation of Company X, the board of directors makes all significant financial and operating decisions. Any matters voted on by the shareholders of Company X are considered protective rights. The board of directors will consist of seven directors, four of which will be appointed by Company A as long as Company A owns more than 45% of the voting stock. The significant decisions are made at the board level by simple majority. The articles of incorporation cannot be changed without a supermajority of the vote of Company X's shareholders. The private equity investors do not have any veto or substantive participating rights (see further discussion in CG 3.4). Assume Company X is not a VIE.

Should Company A consolidate Company X under the voting interest model?

Analysis

Yes. Company A should consolidate Company X under the voting interest model because it has the unilateral right to make the significant financial and operating decisions of Company X as a result of having the right to appoint four of the seven directors.

EXAMPLE CG 7-4

Evaluating a controlling financial interest when voting ownership is widely dispersed

Company A owns 49% of the voting stock of Company B, an established profitable entity. The remaining 51% is widely held and the probability that the entire 51% would vote in concert is remote. Company A does not own any convertible securities, options, or warrants in Company B, and there are no other agreements that affect the voting or management structure of Company B. The directors of Company B are elected by the shareholders of Company B at the annual shareholders meeting by simple majority present, subject to a minimum quorum requirement. The significant decisions of Company B are made at the board level by simple majority vote.

Should Company A consolidate Company B?

Analysis

No. While it is remote that Company A will not be able to elect all of the directors of Company B (as the other shareholders will most likely not all vote, or if they did, would most likely not all vote in unison), Company A does not have the unilateral right or power to direct the significant operational and financial actions of the investee. This unilateral right is generally applied without regard to probability. Thus, absent any other agreements that affect the voting or management structure, Company A should not consolidate Company B as it does not have the unilateral right to appoint the majority of the board of directors of Company B.

7.2.5 ***Control through contractual arrangements***

A reporting entity with less than a majority of voting interests can also gain control of an entity through contractual arrangements. For example, a reporting entity may have:

- An agreement with other voting interest holders that they will always vote in concert with the reporting entity, thus allowing the reporting entity to have a majority voting interest
- A minority voting interest, but by virtue of a contract or other arrangement, have the ability to direct the significant decisions and activities of the entity (see also CG 7.4)

The reporting entity should exercise significant care when determining if it has a controlling financial interest in these situations. The reporting entity should perform a careful analysis of the arrangement, including the rights of all the parties (e.g., termination provisions) and the terms of the arrangement. These contractual arrangements may also cause the entity to be a VIE, and therefore subject to the VIE consolidation model. See CG 4 for guidance on determining whether an entity is a VIE.

7.2.6 ***Noncontrolling shareholder rights***

ASC 810-10-25-2 through ASC 810-10-25-14 addresses the issue of whether consolidation is appropriate when one shareholder or partner has a majority voting interest in another entity, but the powers of the majority shareholder or partner to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling interest holder(s). A similar concept applies to limited partnerships. The approval or veto rights granted to the noncontrolling shareholder(s) or limited partner(s) may be considered as either protective or participating rights. The ASC guidance noted above applies to corporations and limited partnerships that are not VIEs. It does not apply to entities that carry substantially all of their assets at fair value. This section focuses on noncontrolling shareholder rights relating to corporations. Refer to CG 7.3.2 for discussion about limited partner rights relating to limited partnerships.

The assessment of whether noncontrolling shareholder rights should preclude a majority shareholder from consolidating is a matter of judgment that depends on facts and circumstances. The framework in which such facts and circumstances are judged should be based on whether the noncontrolling shareholder rights, individually or in the aggregate, provide for the noncontrolling shareholder to effectively participate in significant decisions that would be expected to be made in the “ordinary course of business.” This assessment should be made at the time a majority voting interest is obtained and should be reassessed if there is a significant modification to the terms of the rights of the noncontrolling shareholder.

Under this framework, the shareholder with the majority voting interest must assess whether the noncontrolling shareholder’s rights are protective rights or substantive participating rights. Protective rights do not overcome the presumption that a majority shareholder exerts control, while substantive participating rights, even though also protective of the investment, would overcome the presumption of control by the majority shareholder.

7.2.6.1 ***Protective rights—corporations & similar entities (VOE model)***

Protective rights held by noncontrolling shareholders do not preclude consolidation. Protective rights are defined as follows under the voting interest model:

Definition from ASC 810-10

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.

ASC 810-10-25-10 provides a list, not intended to be all-inclusive, of noncontrolling shareholder rights that would be considered protective rights and would not preclude the majority voting interest investor from consolidating the investee:

ASC 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.

7.2.6.2 Participating rights—corporations and similar entities (VOE model)

Participating rights are defined as follows under the voting interest model:

Definition from ASC 810-10

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

Participating rights must be substantive in order to overcome the presumption that a majority owner does not have a controlling financial interest in an entity. ASC 810-10-25-11 provides a list, not intended to be all-inclusive, of noncontrolling shareholder rights that should be considered substantive participating rights and would overcome the presumption of consolidation by the holder of a majority voting interest:

ASC 810-10-25-11

Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to effectively participate in either of the following corporate or partnership actions shall be considered substantive participating rights and would overcome the presumption that the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests shall consolidate its investee. The following list is illustrative of substantive participating rights, but is not necessarily all-inclusive:

- a. Selecting, terminating, and setting the compensation of management responsible for implementing the investee's policies and procedures
- b. Establishing operating and capital decisions of the investee, including budgets, in the ordinary course of business.

ASC 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.

A noncontrolling shareholder does not need to participate in all of the rights described in ASC 810-10-25-11(a) and 11(b) to overcome the presumption that the majority owner controls the entity. As indicated in ASC 810-10-25-12, individual rights should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves. The ability of a noncontrolling shareholder to approve either the operating or the capital budget could be a substantive participating right and overcome the presumption that the majority owner controls the entity. Furthermore, a noncontrolling shareholder's right over hiring, firing, or setting the compensation of management could also be a substantive participating right. For example, a right held by a noncontrolling shareholder to veto the setting of compensation of management responsible for implementing the investee's policies and procedures could itself be considered substantive and overcome the presumption of control by the majority owner when the noncontrolling shareholder can

exercise that right without any restrictions or conditions (e.g., no limit on the number of times a noncontrolling shareholder can exercise its right).

For a participating right to be substantive, it does not mean the noncontrolling shareholder must have the ability to initiate actions. Rather, it is only necessary that the noncontrolling shareholder's approval must be obtained by the majority shareholder in order for the majority shareholder to take certain actions. Further, participating rights may be granted by contract (e.g., as a part of the shareholder arrangement) or by law (e.g., certain countries may require that noncontrolling shareholders interests held by local ownership have certain rights with respect to their ownership interest).

Participating rights: VOE vs. VIE definition

Both the voting interest model and the VIE model have their own definitions of a participating right. The definitions, while similar, can result in different applications. The voting interest model focuses on the right to block or participate in the significant financial and operating decisions of the entity made in the ordinary course of business, while the VIE model focuses on the right to block or participate in the decisions that most significantly impact the VIE's economic performance. In addition, ASC 810-10-25-2 through ASC 810-10-25-14 provides examples on what constitutes a participating right under the voting interest model, however, it does not provide any examples on what constitutes a participating right under the VIE model. Given these circumstances, practice has developed where the two definitions can result in different outcomes. For example, a right to veto the compensation of management would likely be considered a substantive participating right under the voting interest model, while it might not significantly impact the entity's economic performance.

Participating rights under the voting interest model would preclude consolidation by a majority shareholder or partner whether exercisable by a single investor or a group of investors. However, under the VIE model, only participating rights exercisable by a single investor (including its related parties and de facto agents) would preclude consolidation.

Under the VIE model, the presence or absence of a participating right may determine whether an entity is a VIE and also which reporting entity may be the primary beneficiary. When assessing whether an entity is a VIE and in particular whether the equity holders as a group lack the power to direct the entity's significant activities, ASC 810-10-15-14(b) clarifies that substantive noncontrolling shareholder participating rights under the voting interest model do not automatically make the entity a VIE as the holders of equity at risk as a group may still have the power to direct the entity's significant activities.

7.2.6.3 *Evaluating whether participating rights are substantive*

Determining whether a participating right is substantive requires judgment. For noncontrolling shareholder rights to be considered substantive, there should be no significant barriers to the exercise of the rights (i.e., conditions, financial penalties, or other operational hurdles making it difficult or unlikely that they could be exercised). As explained in ASC 810-10-25-12, once it is determined that there are no significant barriers to exercise, the likelihood that the rights will be exercised by the noncontrolling shareholder should not be considered when assessing whether a noncontrolling right is a substantive participating right. Noncontrolling shareholder participating rights that are not substantive would not preclude consolidation by an investor who has a majority voting interest in the entity.

ASC 810-10-25-13 provides several factors to consider when assessing whether a participating right is substantive.

ASC 810-10-25-13

The following factors shall be considered in evaluating whether noncontrolling rights that appear to be participating are substantive rights, that is, whether these factors provide for effective participation in certain significant financial and operating decisions that are made in the investee's ordinary course of business:

- a. Consideration shall be given to situations in which a majority shareholder or limited partner with a majority of kick-out rights through voting interests owns such a significant portion of the investee that the noncontrolling shareholder or limited partner has a small economic interest. As the disparity between the ownership interest of majority and noncontrolling shareholders or between the limited partner with a majority of kick-out rights through voting interests and noncontrolling limited partners increases, the rights of the noncontrolling shareholder or limited partner are presumptively more likely to be protective rights and shall raise the level of skepticism about the substance of the right. Similarly, although a majority owner is presumed to control an investee, the level of skepticism about such ability shall increase as the investor's or limited partner's economic interest in the investee decreases.
- b. The governing documents shall be considered to determine at what level decisions are made—at the shareholder or limited partner level or at the board level—and the rights at each level also shall be considered. In all situations, any matters that can be put to a vote of the shareholders or limited partners shall be considered to determine if other investors, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a shareholder or limited partner vote.
- c. Relationships between the majority and noncontrolling shareholders or partners (other than an investment in the common investee) that are of a related-party nature, as defined in Topic 850, shall be considered in determining whether the participating rights of the noncontrolling shareholder or limited partner are substantive. For example, if the noncontrolling shareholder or limited partner in an investee is a member of the immediate family of the majority shareholder, general partner, or limited partner with a majority of kick-out rights through voting interests of the investee, then the rights of the noncontrolling shareholder or limited partner likely would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee.
- d. Certain noncontrolling rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the investee. Noncontrolling rights related to decisions that are not considered significant for directing and carrying out the activities of the investee's business are not substantive participating rights and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. Examples of such noncontrolling rights include all of the following:
 1. Location of the investee's headquarters
 2. Name of the investee

3. Selection of auditors
 4. Selection of accounting principles for purposes of separate reporting of the investee's operations.
- e. Certain noncontrolling rights may provide for the noncontrolling shareholder or limited partner to participate in certain significant financial and operating decisions that are made in the investee's ordinary course of business; however, the existence of such noncontrolling rights shall not overcome the presumption that the majority owner shall consolidate, if it is remote that the event or transaction that requires noncontrolling shareholder or limited partner approval will occur. Remote is defined in Topic 450 as the chance of the future event or events occurring being slight.
- f. An owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests who has a contractual right to buy out the interest of the noncontrolling shareholder or limited partner in the investee for fair value or less shall consider the feasibility of exercising that contractual right when determining if the participating rights of the noncontrolling shareholder or limited partner are substantive. If such a buyout is prudent, feasible, and substantially within the control of the majority owner, the contractual right to buy out the noncontrolling owner or limited partner demonstrates that the participating right of the noncontrolling shareholder or limited partner is not a substantive right. The existence of such call options, for purposes of the General Subsections, negates the participating rights of the noncontrolling shareholder or limited partner to veto an action of the majority shareholder or general partner, rather than create an additional ownership interest for that majority shareholder. It would not be prudent, feasible, and substantially within the control of the majority owner to buy out the noncontrolling shareholder or limited partner if, for example, either of the following 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.

Many factors can influence whether a participating right is substantive. Investors should not only refer to the list above, but also keep in mind that there could be other factors that could influence their assessment. These factors could be different from entity to entity, depending on an entity's operations.

The two main underlying principles of a substantive participating right is that (1) the right over the decision has to be expected to be made in the ordinary course of business, and (2) it has to be expected to have a significant effect on the financial and operating decisions of the entity. If both of these principles are not present, the right would not be a substantive participating right. The ordinary course of business assessment is based on the specific entity's business and can be different from business to business and also industry to industry.

7.2.7 *Assessing individual noncontrolling shareholder rights*

In addition to the factors above, ASC 810-10-55-1 provides various examples of how to assess individual noncontrolling shareholder rights. These examples should not be considered all-inclusive. Judgment should be applied based on the specific facts and circumstances in each arrangement in

order to determine whether the rights of the noncontrolling shareholder should be considered protective or participating, and if participating, whether the rights are substantive.

ASC 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.

When assessing whether noncontrolling shareholder rights are participating or protective, the reporting entity should consider all facts and circumstances, including any contractual provisions, including the examples below, that limit, constrain, or otherwise override the rights of the noncontrolling shareholder.

- The noncontrolling shareholder only has the right to approve the acquisition or disposition of assets over a certain dollar limit. The reporting entity should determine whether that dollar limit causes the right to be non-substantive. For instance, if the entity's long-term plan projects that the dollar limit would not be exceeded in the ordinary course of business, the noncontrolling shareholder's veto right may not be considered substantive.
- In the event of a disagreement between the reporting entity and the non-controlling shareholder, there is a dispute resolution mechanism in place that ultimately allows the reporting entity to prevail. For example, the noncontrolling shareholder can only veto the appointment of an executive position three times and after the third time, the reporting entity is able to make the

appointment solely on its own. In this case, the noncontrolling shareholder's veto right may not be considered substantive because even though the majority shareholder might have to make four attempts to appoint the executive it desires, four attempts would likely not be considered overly burdensome, and the majority shareholder ultimately has the ability to appoint the executive position.

- The provision may not allow the noncontrolling shareholder to effectively participate in the entity's significant financial and operating decisions. For example, if the reporting entity and the non-controlling shareholder cannot agree on the operating budget, the current year budget defaults to last year's budget adjusted for inflation or some other factor. If the entity is a mature business for which year-to-year operating budgets are not expected to vary significantly, the noncontrolling shareholder's veto right may not be considered substantive as the rights do not allow the noncontrolling shareholder to effectively participate in a significant decision. Alternatively, consider an example where a reporting entity and the noncontrolling shareholder cannot agree on the operating budget and the disagreement is resolved and decided by an independent arbitrator. In this case, regardless of the arbitration outcome, the participating right would be considered substantive since the reporting entity would not be able to make the decision regarding the operating budget unilaterally.

7.3 Voting interest model—LPs and similar entities

A limited partnership is an association of one or more general partners with unlimited liability and one or more partners with limited liability. It is usually managed by the general partner or partners who may be subject to limitations, as imposed by the partnership agreement. For LPs and similar legal entities, both the general partner (and its affiliates) and the limited partner(s) must first determine the applicability of the VIE consolidation model, including whether (1) the entity is a VIE or (2) the partners or partnership are eligible for one of the scope exceptions. This determination must be performed before considering any other authoritative literature regarding consolidation of the LP. If the partnership is a VIE and the partners or partnership are not eligible for any of the scope exceptions under the VIE guidance, ASC 810 requires that the primary beneficiary, if any, consolidate the VIE. If the partnership is not a VIE, the partners would apply the voting interest model for partnerships in accordance with ASC 810, as further discussed in this section.

The consolidation guidance for LPs also applies to other similar legal entities. A similar legal entity is an entity that has governing provisions and economic characteristics that are the functional equivalent of an LP, and could include entities such as limited liability companies, limited liability partnerships, and others. Therefore, a reporting entity with an interest in a similar legal entity would need to first determine whether the governing provisions of the entity are the functional equivalent of an LP (see CG 7.1.1).

An LP can only be a voting interest entity if the limited partners have kick-out rights (including liquidation rights) and/or substantive participating rights. If the limited partners do not have these rights, the LP is a VIE. Therefore, as illustrated in Figure CG 7-1, under the voting interest model for LPs, only a limited partner can consolidate an LP. Said differently, if a general partner consolidates an LP, the LP is a VIE.

Controlling financial interest

For purposes of assessing a controlling financial interest, one must evaluate whether kick-out rights (including liquidation rights) are held by limited partners, since these rights may be the equivalent of voting interests held by shareholders of a corporation. Therefore, a limited partner with a majority of kick-out rights through voting interests would usually control and consolidate the LP. However, if there are other limited partners holding substantive participating rights, then those rights would overcome the usual condition of control held by the limited partner with a majority of kick-out rights through voting interests. If none of the individual limited partners are able to exercise the kick-out right unilaterally, no partner would have a controlling financial interest in the LP.

ASC 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.

The guidance states that kick-out rights are exercised “through voting interests,” which refers to the voting interest that a limited partner has in the kick-out right. The voting interest that a limited partner has in the kick-out right is generally equal to its economic interest in the LP.

For example, assume an LP has a general partner with a 20% ownership interest and four limited partners each having a 20% ownership interest. The four limited partners each have an equal vote in the kick-out right based on their ownership interest, thus each limited partner would have a 20% “voting interest” in deciding whether to exercise the kick-out right to remove the general partner. The general partner does not have a voting interest in the kick-out right. In this example, a simple majority of the voting interests in the kick-out right held by the limited partners would be 41% of the voting interests in the kick-out right, calculated as 51% of the 80% held by the limited partners. Since none of the limited partners individually hold more than 41% of the voting interests in the kick-out rights, none of the limited partners would consolidate the LP under the voting interest model. See CG 4.4.5.2 for further analysis and examples of the impact of kick-out rights on the VIE model.

Sometimes the general partner may also have a vote in deciding whether it should be removed. Kick-out rights held by the general partner and its related parties should be excluded when assessing whether a simple majority or lower threshold of limited partners can exercise the kick-out right. Therefore, only the kick-out rights held by the limited partners should be considered in the assessment.

7.3.1 **Substantive kick-out rights and liquidation rights (VOE model)**

For LPs and similar legal entities, kick-out rights are defined as:

Definition from ASC 810-20-20

Kick-Out Rights (Voting Interest Entity Definition): The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

Since an LP would be a VIE if the limited partners do not have kick-out rights or substantive participating rights, the assessment of the kick-out rights and substantive participating rights are generally performed when determining whether the LP is a VIE. If the LP is not a VIE, these same rights are then considered in assessing whether a single limited partner, if any, has a controlling financial interest in the LP. That is, the assessment performed during the VIE determination is carried over to the assessment of whether a single limited partner, if any, has a controlling financial interest in the LP.

By definition, kick-out rights are limited to the rights held by limited partners to remove the general partner(s). As mentioned in ASC 810-10-15-14(b)(1)(ii), in order for an LP to not be a VIE, the kick-out rights must be exercisable by a simple majority or lower threshold of limited partner(s). In determining the simple majority required to kick-out the general partner(s), any kick-out rights held through voting interests by general partner (regardless of whether they are embedded in the general partner interest or through any limited partner interest held by the general partner), by entities under common control with the general partner, and by others acting on behalf of the general partner should be excluded. Also, in determining the simple majority required to kick-out the general partner, the reporting entity needs to calculate and ensure that all possible combinations that represent a simple majority of the limited partners' voting interests allow for the limited partners to kick-out or remove the general partner. See CG 4.4.5.2 for further analysis and examples of the impact of kick-out rights on the VIE model.

Kick-out rights must be substantive in order for them to be assessed under the VIE model pursuant to ASC 810-10-15-14(b)(1)(ii), as well as under the voting interest model. For kick-out rights to be considered substantive, the 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. If the general partner or one of its related parties is in a position to block the exercise of the kick-out right, the limited partners will likely not have a substantive kick-out right. Refer to CG 4.4.5.2 for more discussion about evaluating whether kick-out rights (including liquidation rights) are substantive.

Kick-out rights are required to be assessed continuously. This is especially important when limited partners are investing in or divesting from the LP. If the limited partners fail to have a kick-out right that meets the requirements described in ASC 810-10-15-14(b)(1)(ii) and ASC 810-10-25-2 through ASC 810-10-25-14C, the LP would become a VIE. This could lead to a change in any consolidation conclusion.

Rights held by general partners to buy out limited partners are not considered kick-out rights as illustrated in Example CG 7-5.

EXAMPLE CG 7-5

Buy/sell right between general partner and limited partner

Partnership X was formed to acquire a single commercial real estate building and to lease the space to multiple tenants. The sole general partner owns 20% of the LP and the sole limited partner (a party unrelated to the general partner) owns 80% of the LP. The partnership agreement states that either partner has the right to offer to buy the other partner's interest. The buy/sell provision is as follows:

- Offeror can request that offeree sell its interest to offeror at a price determined by the offeror
- Once an offer is made, offeree must either (1) sell its interest to the offeror, or (2) buy the offeror's interest at the same price per unit

Once the buy/sell provision is triggered, either the offeror or the offeree would end up owning the partnership assets. The limited partner does not have substantive participating rights or unilateral kick-out rights over the general partner as described in CG 7.3.2.

Does the buy/sell right qualify as a kick-out right or a liquidation right?

Analysis

A buy/sell right is generally not a kick-out right or a liquidation right that enables the limited partner to remove the general partner without cause. If the limited partner initiates the buy/sell right, the general partner would control the ultimate outcome of the transaction. The general partner would have the right to either sell its interest to the limited partner or buy the limited partner's interest. The determination that the general partner has the financial ability to buy out the limited partner's interest requires careful consideration. If the general partner has the financial ability to buy out the limited partner's interest (e.g., the general partner is financially capable of purchasing the limited partner's interest or attracting new limited partners), the buy/sell right would not be considered a kick-out right.

In this case, the LP would be a VIE because the buy/ sell right does not represent a kick-out right or liquidation right. The partners would apply the guidance in CG 5 to identify the primary beneficiary of the VIE, if any.

Definition of "without cause"

Kick-out rights must be exercisable "without cause" in order to be a valid kick-out right. ASC 810-10 includes the following definitions:

Definition from ASC 810-10

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 means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners.

Based on the definition of without cause, a provision would only be a kick-out right if it gives the limited partners the right to remove the general partner for no reason, without regard to probability or any condition. Rights to remove the general partner with cause do not meet the definition of a kick-out right (unless the specified causes lack substance). For example, agreements with provisions that give limited partners the right to liquidate the partnership when there is a change in the LP's key executives, but the general partner controls the change in executives, would not meet the definition of a kick-out right since it can be exercised only with cause.

7.3.1.1 *Liquidation rights—LP's and similar entities (VOE model)*

As described in ASC 810-10, liquidation rights are included in the definition of kick-out rights. Therefore, the guidance for kick-out rights should be applied in the same manner for liquidation rights (e.g., simple majority concept and no barriers to exercise). However, barriers to exercise for liquidation rights may be different from barriers to exercise for kick-out rights and should be evaluated when assessing whether the rights are substantive. For example, a liquidation right may only allow the limited partners to receive cash upon liquidation as opposed to the assets under management, and thus the limited partners may be less likely to exercise their liquidation rights. However, the mere fact that the limited partners would not receive the assets under management is not by itself a barrier to exercise. All facts and circumstances should be considered in making this assessment, including, for example, why liquidation rights were granted to the limited partners instead of kick-out rights. For example, limited partners of an LP that invest in relatively liquid investments may not have kick-out rights over the general partner because those limited partners have liquidation rights that, if exercised, have the same effect on the general partner as a kick-out right. That is, if the limited partners sought to remove the general partner, they collectively could exercise their liquidation rights. The partnership would terminate, and a new partnership could be formed to make similar liquid investments with a new general partner.

7.3.1.2 *Redemption rights—LP's and similar entities (VOE model)*

As an alternative to providing limited partners with liquidation rights, a partnership agreement may provide the limited partners the right to redeem their interest in whole or in part and, therefore, withdraw from the partnership. However, redemption rights are generally not the equivalent of liquidation rights or kick-out rights. Since redemption rights normally do not result in the complete dissolution of the LP (i.e., exercise of those rights only require that the partnership repurchase the requesting limited partner's interest), the partnership's activities continue after redemption. Accordingly, redemption rights generally would not be considered in the consolidation analysis, unless the redemption effectively requires liquidation of the partnership.

ASC 810-10-25-14B

The 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.

Normally, it will be difficult to ascertain that redemption rights held by the limited partner(s) could result in an effective liquidation of the partnership. There must be credible evidence that the right is effectively similar to a liquidation right and that there are no barriers to exercising that right.

However, there may be certain limited circumstances in which the right to redeem the partnership interest results in the liquidation of the partnership. In certain cases, if partnership redemptions reach a certain threshold, the automatic liquidation of the partnership may be triggered. In other cases, a limited partner's right to have its interest redeemed might compel the general partner to liquidate the partnership in order to finance the redemption. Each case should be assessed based on the facts and circumstances in determining whether a redemption right rises to the level of a liquidation right.

7.3.2 ***Substantive participating rights—LP's and similar entities (VOE model)***

Participating rights are defined as follows under the voting interest model:

Definition from ASC 810-10

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.

Excerpt from 810-10-25-14C

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.

As indicated in CG 7.3.1, the assessment of substantive participating rights for LPs is generally performed during the VIE assessment of the LP. This is because if limited partners of an LP do not have either substantive participating rights or kick-out rights, the LP would be a VIE. However, there can be a few exceptions to this assessment sequence. For example, if it is determined that a single limited partner has a kick-out right, any rights that the other limited partners may have might not be assessed during the VIE assessment of the LP. Assuming the LP is not a VIE, any rights that the other limited partners have will have to be assessed during the voting interest assessment in determining whether the single limited partner has a controlling financial interest in the LP.

Some partnership agreements may allow limited partners to participate in decisions that could have a significant impact on the partnership's business (i.e., significant financial and operating decisions), thereby limiting the rights of the general partner or a limited partner with majority kick-out rights through voting interests. As previously described, if limited partners are able to exercise substantive participating rights over the general partner based on their voting interests, the LP would not be considered a VIE based on the guidance in ASC 810. Assuming none of the other VIE criteria are met, the LP would be considered a voting interest entity. Under the voting interest model, similar to noncontrolling shareholder participating rights in corporations, if limited partners have substantive participating rights, neither the general partner nor the limited partner with a majority of kick-out rights through voting interests would control the LP.

The assessment of whether a limited partner's participating rights are substantive follows the same guidance in ASC 810-10-25-11 through ASC 810-10-25-13 for the assessment of noncontrolling

shareholder participating rights in corporations. A limited partner's veto right to block actions that are not made in the "ordinary course of business" are protective rights. Refer to CG 7.3.1 for more discussion about distinguishing participating rights versus protective rights, and evaluating whether participating rights are substantive.

The guidance does not require that a substantive participating right be exercised by at least a simple majority or less of the limited partners (as a kick-out right requires). However, if the percentage of limited partners required to exercise a substantive participating right is very high, this should be considered as a potential barrier to exercise of the right.

7.4 Consolidation of entities controlled by contract

ASC 810-10-25 describes the framework for determining when a controlling financial interest has been established through a contractual management arrangement, thus requiring consolidation by the controlling entity.

While this issue was raised specifically to address contractual arrangements between entities that are in business to practice and dispense medicine (physician practices) and entities that are in business to manage the operations of those physician practices (physician practice management entities, or PPMs), it also applies to similar arrangements in other industries.

This guidance only applies to an entity that is not a VIE. Since an entity that is controlled by contract is almost always a VIE (as the equity holders at risk lack the decision making ability), we believe the application of this guidance may be very limited. Therefore, the entity would likely be subject to the VIE model and not the consolidation by contract guidance.

The following requirements must be met for a PPM (reporting entity) to have a controlling financial interest in a physician practice:

- Term – the term of the contractual arrangement between the PPM and the physician practice is at least 10 years or for the entire remaining legal life of the physician practice, and the arrangement is not terminable except in the cases of gross negligence, fraud, or other illegal acts by the PPM, or bankruptcy of the PPM. The term must be determined based on its substance rather than its form, and thus, both the original term and renewal or cancellation provisions must be considered. As indicated, the reasons for termination are intended to be very specific and narrow in scope.
- Control – the PPM has unilateral decision making over (1) ongoing, major, or central operations of the physician practice, except for the dispensing of medical services, and (2) compensation for the licensed medical professionals as well as the ability to establish and implement guidelines for the selection, hiring, and firing of them. Decision making over ongoing, major, or central operations of the physician practice must include authority over scope of services, patient acceptance policies and procedures, pricing of services, negotiation and execution of contracts, and the establishment and approval of operating and capital budgets. It also includes issuance of debt if debt financing is an ongoing or major source of financing for the physician practice. These significant decisions reflect the minimum level of decision making needed for the PPM to meet the control requirement. The dispensing of medical services is excluded from the PPM's control only because state law requires licensed medical professionals to dispense medical services and a PPM would generally not satisfy that requirement.

- Financial interest – the PPM has a significant financial interest in the physician practice that both (1) is unilaterally saleable or transferable by the PPM and (2) provides the PPM with the right to receive income, both as ongoing fees and as proceeds from the sale of its interest in the physician practice, in an amount that varies based on the operating performance and fair value of the physician practice. If the PPM’s financial interest in the physician practice does not meet both of these criteria, the PPM would not be deemed to have a financial interest in the physician practice.

7.4.1 Nominee shareholder

The consolidation by contract model also introduces the concept of a nominee shareholder(s) into the consolidation model. A nominee shareholder may or may not be used in the PPM/physician practice structure to achieve consolidation. If used, the nominee shareholder is generally the 100% equity shareholder of either a new or the existing physician practice. Simultaneously, the nominee shareholder and the PPM enter into a management agreement that gives control of the physician practice to the PPM. Effectively, the nominee shareholder is an agent of the PPM. The nominee shareholder’s relationship with the PPM perpetually has all the following characteristics:

- Time frame – the PPM can change or replace the nominee shareholder at any time and as many times as it so chooses.
- Discretion – the PPM has the sole discretion to establish or change the nominee shareholder and can name anyone it so chooses as the new nominee shareholder.
- Impact – the PPM and the nominally owned entity incur no more than nominal cost to change the nominee shareholder and there is no significant adverse impact to the physician practice upon a change.

The concept of a nominee shareholder is also very common in many VIE arrangements, including foreign ownership structures, local management agreements, etc.

***Chapter 8:
Intercompany
transactions, proportionate
consolidation, and other
matters – updated July 2023***

8.1 *Intercompany transactions and other matters overview*

This chapter discusses considerations related to intercompany transactions between a parent and its subsidiaries. This chapter also discusses other unique accounting matters such as collaborative arrangements, proportionate consolidation, and not-for-profit organization consolidation considerations.

Refer to FSP 18.6.2 for guidance on consolidation procedures when a reporting entity is required to consolidate a subsidiary with a different period end (i.e., lag reporting). Refer to EM 4.4 for additional guidance on lag reporting.

8.2 *Intercompany transactions*

The term “intercompany (intra-entity) income” as used in this chapter refers to profit arising from transfer of inventories, properties, or other assets between companies included in consolidated financial statements (including VIEs). Intercompany profit may also arise from the sale of services or other charges (e.g., interest) that are capitalized by the purchasing affiliated company.

The general objective of intercompany income elimination in consolidated financial statements is to exclude from consolidated shareholders’ equity the profit or loss arising from transactions within the consolidated entity and to correspondingly adjust the carrying amount of assets remaining in the consolidated entity. Generally, the gross profit of the selling company is used to adjust the carrying amounts; however, where the selling company would ordinarily capitalize inventorable costs, it is appropriate for such costs to be capitalized in consolidation by adjustment of the amount of profit eliminated.

ASC 323-10 discusses the equity method of accounting as it applies to corporate joint ventures and investees and states that “intra-entity (intercompany) income shall be eliminated until realized by the investor or investee as if the investee company were consolidated.” However, ASC 323-10-35-9 permits partial elimination of intercompany income on transactions with companies accounted for by the equity method. Refer to EM 4.2 for a discussion of intercompany income elimination under the equity method.

Any profit or loss on a leasing transaction with a related party investee should be accounted for in accordance with the principles set forth in ASC 810-10 or ASC 323-10 as appropriate.

Intercompany income should be eliminated from the applicable asset reflected in the consolidated balance sheet on a before-tax basis. See TX 2.4.5 for a discussion of the tax effects of intercompany transactions.

8.2.1 *Accounting for intercompany transactions with VIEs*

An entity should consolidate a VIE for which it is the primary beneficiary pursuant to ASC 810-10-25-38 through ASC 810-10-25-38G. After a primary beneficiary initially consolidates a VIE, the basic principles of consolidated financial statements for voting interest entities in ASC 810-10 apply to the primary beneficiary’s accounting for the consolidated VIE, with one exception. For a VIE, intercompany income eliminations may not be attributed pro rata between the primary beneficiary and the noncontrolling interests.

ASC 810-10-35-3 explicitly states that (1) any intercompany fees, as well as other sources of income or expenses between a primary beneficiary and a consolidated VIE, should be eliminated against the related expense or income of the variable interest entity and (2) the resulting effect of that elimination on net income or expense of the variable interest entity should be attributed to the primary beneficiary and not to any noncontrolling interest (NCI) in the consolidated financial statements. Therefore, when consolidating a VIE, the elimination of the full intercompany profit should be attributed to the primary beneficiary.

ASC 810-10-35-3

The principles of consolidated financial statements in this Topic apply to primary beneficiaries' accounting for consolidated variable interest entities (VIEs). After the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE shall be accounted for in consolidated financial statements as if the VIE were consolidated based on voting interests. Any specialized accounting requirements applicable to the type of business in which the VIE operates shall be applied as they would be applied to a consolidated subsidiary. The consolidated entity shall follow the requirements for elimination of intra-entity balances and transactions and other matters described in Section 810-10-45 and paragraphs 810-10-50-1 through 50-1B and existing practices for consolidated subsidiaries. Fees or other sources of income or expense between a primary beneficiary and a consolidated VIE shall be eliminated against the related expense or income of the VIE. The resulting effect of that elimination on the net income or expense of the VIE shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.

Accordingly, except as noted above, the consolidation principles described herein should be followed when accounting for consolidated variable interest entities. Within this chapter, the term "parent" includes the "primary beneficiary" as defined in the Master Glossary of the ASC, and the terms "consolidated subsidiary" or "majority-owned subsidiary" include a "consolidated variable interest entity" as defined in the Master Glossary of the ASC for which the primary beneficiary may own some or no equity interest.

8.2.2 Basic principles of intercompany transactions

ASC 810 establishes basic consolidation principles, which include (1) any intercompany income on assets remaining within the consolidated group of companies should be eliminated and (2) the amount of intercompany income to be eliminated is not affected by the existence of an NCI.

ASC 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).

ASC 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.

In consolidation, the following are observed practices related to recurring transactions (e.g., inventory) with partially-owned subsidiaries:

- When a sale is made by the parent to a partially-owned subsidiary, the entire elimination of the intercompany gain or loss is generally attributed to the controlling interest.
- When the profit arises from the sale by a partially-owned subsidiary to the parent, the entire intercompany profit elimination is either (1) attributed entirely to the controlling interest or (2) attributed proportionately between the controlling and NCI (this method is not allowed for VIEs, as described in CG 8.2.1). Refer to CG 8.2.3 for additional details.

In either case, the amount of profit eliminated from the asset is not affected by the existence of an NCI in the subsidiary. The complete elimination of the intercompany income is consistent with the underlying assumption that consolidated statements represent the financial position and operating results of a single economic entity.

As further discussed in BCG 7.1.2, sales or transfers of fixed assets and other long-term assets between entities under common control are generally recorded at their carrying amounts at the day of transfer.

8.2.3 Parent sells to partially-owned subsidiary

For transactions in which a parent company or primary beneficiary sells to a partially-owned subsidiary or a consolidated VIE, the elimination of the entire intercompany profit is usually attributed to the controlling interest. In consolidated financial statements, the full attribution of eliminated profits to the controlling interest is appropriate because the intercompany transactions in such cases are not viewed as arm's-length even if expressed in terms of objective market prices. The same guidance should be applied in the parent's consolidated financial statements in situations in which a wholly-owned subsidiary sells to a partially-owned subsidiary.

The attribution of the full elimination to the controlling interest is demonstrated in Example CG 8-1.

EXAMPLE CG 8-1

Parent sells to partially-owned subsidiary – full intercompany income elimination is attributable to parent

At the beginning of the year, Company A purchases a 60% interest in Company B for \$120. At that time, the fair value of Company B's net assets is \$200, and the fair value of the NCI is \$80. Company B's total capital is \$200.

During the year, Company A sells goods to Company B that are in Company B's inventory at year end. The transaction resulted in a profit to Company A as follows:

Selling price	\$ 100
Less: cost of sales	(60)
Profit	\$ 40

Sales and expense information for Company A and Company B on a separate company basis, before giving effect to intercompany eliminations and NCI income (expense), is as follows:

	Company A	Company B
Sales	\$ 1,000	\$ 400
Cost of sales	(600)	(260)
Profit	\$ 400	\$ 140
Selling and administrative	160	40
Net income	\$ 240	\$ 100

How should Company A account for the intercompany eliminations assuming no allocation is made to the noncontrolling interest?

Analysis

The following journal entries demonstrate the intercompany eliminations when the entire intercompany income eliminated in consolidation is attributed to the controlling interest.

To eliminate Company A's investment in Company B:

Dr. Capital stock in Company B	\$ 120	
Cr. Investment in Company B		\$ 120

To eliminate intercompany sales and intercompany income in inventory that has not been sold by Company B at year end:

Dr. Sales	\$ 100	
Cr. Cost of sales		\$ 60
Cr. Inventory		\$ 40

To record NCI in Company B:

Dr. Capital stock in Company B (\$200 total capital x 40%)	\$ 80
Cr. Noncontrolling interest in Company B	\$ 80

Summary of elimination attributed to controlling interest

Consolidated net income prior to elimination of intercompany profit	\$ 340
Elimination of intercompany profit in inventory	(40)
Consolidated net income	\$ 300
Net income attributable to NCI	40
Net income attributable to Company A	\$ 260

The NCI in income of Company B would be calculated as Company B's net income of \$100 x 40% NCI in Company B. The result is that the full amount of the intercompany profit elimination would be attributed to the controlling interest.

The following table illustrates the attribution of Company B's net income in consolidation and the entire intercompany elimination to Company:

	Company A	NCI	Total
Share of Company B's net income	\$ 60	\$ 40	\$ 100
Full attribution of intercompany elimination to controlling interest	(40)	—	(40)
Total	\$ 20	\$ 40	\$ 60

Under the full attribution approach, the noncontrolling interest would recognize profit on the sale of inventory to the parent.

Company A would not recognize profit on the intercompany sale of inventory. Company A would recognize its standalone profit of \$240, plus its 60% share of the subsidiary's \$100 income, less the entire income on the intercompany transaction of \$40.

In Year 2, assume Company B sells all of the inventory. Cost of sales would have to be reduced by the prior period's intercompany profit elimination, the effect of which would be attributed entirely to the controlling interest.

For example, in Year 2, assume Company B sells all of the inventory it purchased from Company A during Year 1 for \$120. The earnings of Company B would still be allocated 60%/40% to Company A and the NCI, but because Company A would need to also add back the prior period intercompany profit elimination, the amount attributed to the controlling interest would be \$52, calculated as follows:

Company B selling price	\$ 120
Company B cost of sales	(100)
Company B profit	<u>\$ 20</u>
Company A's 60% share of Company B profit	\$ 12
Plus: reduction in cost of sales	40
Total income attributable to Company A	<u><u>\$ 52</u></u>

8.2.4 *Partially-owned subsidiary sells to parent*

When a partially-owned subsidiary sells to a parent company, there are two acceptable approaches under ASC 810-10-45-18 to attributing the elimination of the intercompany profit or loss. The elimination of intercompany profit or loss may either be fully attributed to the controlling interest, or attributed proportionately between the controlling and noncontrolling interests.

Under the full attribution approach, net income attributable to the parent is charged for the entire intercompany income, including the noncontrolling interest's share. This approach is less complex in application and is based on a view that the parent controls the sale and should eliminate the entire sale in its accounting. However, some believe that the full attribution of the elimination of the intercompany profit made on a sale by a partially-owned subsidiary to its parent understates net income attributable to the parent by the share of intercompany income earned from sale to the NCI.

The attribution of the intercompany income elimination proportionately between the parent and noncontrolling interests reflects the net income earned by the parent for its share of intercompany net income earned to the extent of outside interests. However, it has the disadvantage in consolidated financial statements of understating the equity of the NCI in net assets of the subsidiary by the amount of profit remaining in the parent's assets (i.e., inventory) attributable to the noncontrolling interest of the selling subsidiary. Further, this approach cannot be applied when consolidating a VIE as described in ASC 810-10-35-3. See CG 8.2.1 for further information.

In situations in which a partially-owned subsidiary sells to a wholly-owned subsidiary, the wholly-owned buying subsidiary should be regarded as the parent entity and the same guidance as discussed above should be applied in the parent's consolidated financial statements. In situations in which a partially-owned subsidiary sells to a partially-owned subsidiary, the entire amount of intercompany profit must be eliminated in arriving at consolidated net income. The amount of the intercompany profit elimination attributed to the NCI should be determined consistently with the approach adopted by the entity for sales to the parent.

A "cost company" is a joint venture formed to serve as a source of supply in which the venturers agree to take production of the investee proportionate to their respective interests. This is substantially a cost-sharing arrangement, and the existence of an outside interest does not increase cost of supplies to the consolidated entity. For this reason, the intercompany income elimination is required to be attributed entirely to the parent.

Example CG 8-2 demonstrates the two different approaches of attributing the elimination of intercompany profit or loss.

EXAMPLE CG 8-2

Partially-owned subsidiary sells to parent – two approaches

At the beginning of the year, Company A purchases a 60% interest in Company B for \$120. At that time, the fair value of Company B's net assets is \$200, and the fair value of the NCI is \$80. Company B's total capital is \$200.

During the year, Company B sells goods to Company A that are in Company A's inventory at year end. The transaction resulted in a profit to Company B as follows:

Selling price	\$ 100
Less: cost of sales	(60)
Profit	\$ 40

Sales and expense information for Company A and Company B on a separate company basis, before giving effect to intercompany eliminations and NCI income (expense), is as follows:

	Company A	Company B
Sales	\$ 1,000	\$ 400
Cost of sales	(600)	(260)
Profit	\$ 400	\$ 140
Selling and administrative	160	40
Net income	\$ 240	\$ 100

How should Company A eliminate the intercompany profit using full attribution to the controlling interest?

Analysis – full attribution approach

The following journal entries demonstrate the intercompany eliminations when the entire intercompany income eliminated in consolidation is attributed to the controlling interest.

To eliminate Company A's investment in Company B:

Dr. Capital stock in Company B	\$ 120	
Cr. Investment in Company B		\$ 120

To eliminate intercompany sales and intercompany income in inventory that has not been sold by Company A at year end:

Sales	\$ 100	
Cost of sales		\$ 60
Inventory		\$ 40

To record NCI in Company B:

Capital stock in Company B	\$ 80	
Noncontrolling interest in Company B		\$ 80

Under the full attribution approach, the noncontrolling interest would recognize profit on the sale of inventory to the parent. The attribution of income of Company B to the NCI would be calculated as Company B's net income of \$100 x 40% NCI in Company B.

Company A would not recognize profit on the intercompany sale of inventory. Company A would recognize its standalone profit of \$240, plus its 60% share of the subsidiary's \$100 income (\$60), less the entire income on the intercompany transaction of \$40.

The following table illustrates the attribution of Company B's net income in consolidation and the entire intercompany elimination to Company A.

	Company A	NCI	Total
Share of Company B's net income	\$ 60	\$ 40	\$ 100
Full attribution of intercompany elimination to controlling interest	(40)	—	(40)
Total	\$ 20	\$ 40	\$ 60

In Year 2, assume Company A sells all of the inventory. Cost of sales would have to be reduced by the prior period's intercompany profit elimination, the effect of which would be attributed entirely to the controlling interest. The entire \$40 profit would be attributed to Company A in Year 2, such that by the end of Year 2, Company A would have recognized its full 60% share of Company B's profit.

How should Company A eliminate the intercompany profit if it is attributed proportionately between the controlling and noncontrolling interest?

Analysis – proportionate attribution approach

The following journal entries demonstrate the intercompany eliminations when the entire intercompany profit eliminated in consolidation is attributed proportionately between the controlling and noncontrolling interests. This method is not permissible for consolidated VIEs.

To eliminate Company A's investment in Company B:

Capital stock in Company B	\$ 120	
Investment in Company B		\$ 120

To eliminate intercompany sales and intercompany income in inventory which has not been sold by Company A at year end:

Sales	\$ 100	
Cost of sales		\$ 60
Inventory		\$ 40

To record NCI in Company B:

Capital stock in Company B	\$ 80	
Noncontrolling interest in Company B		\$ 80

Under the proportionate attribution approach, the noncontrolling interest would recognize income of \$24, which represents its 40% share of Company B's \$100 net income (\$40), less its 40% share of the remaining profit in inventory of \$40 (\$16).

In addition to its standalone profit of \$240, Company A would recognize its 60% share of Company B's \$100 net income (\$60), less its 60% share of the remaining profit in inventory of \$40 (\$24).

The following table illustrates the proportionate attribution of Company B's net income and the intercompany elimination in consolidation to Company A and the NCI.

	Company A	NCI	Total
Share of Company B's net income	\$ 60	\$ 40	\$ 100
Proportionate attribution of intercompany elimination	(24)	(16)	(40)
Total	\$ 36	\$ 24	\$ 60

In Year 2, when Company A sells all of the inventory, cost of sales would have to be reduced by the prior period's intercompany profit elimination, and a similar adjustment made to the attribution of income to Company B. In Year 2, 60% of Company B's \$40 profit (\$24) would be attributed to Company A, such that by the end of Year 2 Company A would have recognized its full 60% share of Company B's profit.

The summary below compares the consolidated net income and adjustments under the two approaches.

	Full attribution to controlling interest	Partial attribution to NCI
Consolidated net income prior to elimination of intercompany profit	\$ 340	\$ 340
Elimination of intercompany profit	(40)	(40)
Consolidated net income	\$ 300	\$ 300
Net income attributable to NCI	40	24
Net income attributable to Company A	\$ 260	\$ 276

8.2.5 Intercompany inventory transactions and the lower of cost or net realizable value test

When intercompany transactions result in a profit, the new basis (cost) of the inventory on the books of the company holding the inventory will include the entire intercompany profit. The intercompany profit and related income taxes are normally eliminated in consolidation.

As part of its normal inventory accounting, as prescribed by ASC 330, *Inventory*, inventory is recorded at the lower of cost or net realizable value (NRV). NRV is defined as the estimated selling price less the cost of completion and sale. If cost exceeds net realizable value, an inventory write-down should be recorded. To the extent that the write-down gives rise to an immediate or a future (upon realization of the inventory loss) tax deduction that, under ASC 740, *Income Taxes*, meets the “more likely than not” criterion, a tax benefit would be recorded as part of the normal calculation of income tax expense. The adjusted amounts should be used for consolidation purposes, which means that the parent and NCI in the company holding the inventory will reflect their respective shares of the recorded inventory write-down net of any tax benefit recorded.

In consolidation, the intercompany income (and related tax effect) that is to be eliminated should be reduced to consider the inventory write-down recorded by the company holding the inventory.

The procedures discussed above are summarized in the following steps:

- The company holding the inventory should apply the lower of cost or net realizable value test based on its carrying cost.
- If a write-down is required, it should be recorded in the books of the company holding the inventory. The write-down will be reflected in that company’s calculation of its income tax provision and thus the tax benefit related to the write-down (to the extent recognizable under ASC 740) will be reflected in the standalone entity financial statements.
- The financial statements of the company holding the inventory, as adjusted, should be used in consolidation. As a result, the consolidated financial statements will reflect both the parent’s and the NCI’s respective shares of that net loss.

- From a consolidated point of view, it is generally necessary to adjust the parent's share of intercompany income that would ordinarily be eliminated in consolidation in order to partially or fully offset the parent's share of the write-down recorded by the company holding the inventory. However, if the parent's share of the write-down is greater than the parent's share of the intercompany income elimination, then the adjustment for the parent's share of the intercompany income elimination is not necessary. On the other hand, if the parent's share of the write-down is less than its share of the intercompany income elimination, then the amount of the normal intercompany elimination should be reduced by the parent's share of the write-down.
- Whenever the amount of profit eliminated in consolidation is adjusted to take into account an inventory write-down, a corresponding adjustment may need to be made to the income taxes previously paid on the intercompany income (i.e., deferred charge) in consolidation. This is because the amount that continues to be deferred is subject to an after-tax realization test, as discussed in TX 2.4.4.1.

Example CG 8-3 illustrates the accounting for a write-down of inventory purchased by a partially-owned subsidiary from its parent that was sold at a profit.

EXAMPLE CG 8-3

Parent sells inventory to partially-owned subsidiary – lower of cost or NRV test

At the beginning of the year, Company A purchases a 60% interest in Company B for \$120. At that time, the fair value of Company B's net assets is \$200, and the fair value of the NCI is \$80. Company B's total capital is \$200.

Intercompany profits are eliminated in their entirety and fully attributed to the parent (Company A) as described in Example CG 8-1.

During the year, Company A sells goods to Company B that are in Company B's inventory at year end. There were no other intercompany transactions during the year. The intercompany sale of inventory resulted in a profit to Company A and a related tax expense on a standalone basis as follows:

Selling price	\$ 100
Less: cost of sales	(60)
Profit before tax	\$40

At the end of the year, the goods acquired from Company A by Company B have an NRV of \$70. As shown below, Company B writes down the inventory to net realizable value, with the \$30 adjustment to cost of sales reflected in Company B's income statement. In computing its current provision for income taxes, the \$30 write-down is fully deductible.

	Company B	NRV write-down	Company B after write-down
Inventory	\$ 100	\$ (30)	\$ 70
Sales	—	—	—
COGS	—	(30)	(30)
Pretax (loss)	—	\$ (30)	\$ (30)

Analysis

The following journal entries demonstrate the intercompany eliminations that should be recorded in consolidation, as well as the impact to Company A's accounts of the inventory write-down that was recorded by Company B. For ease of illustration, tax effects have been ignored.

To eliminate intercompany sales and intercompany income in inventory before giving effect to the inventory write-down recorded by Company B:

Sales	\$ 100	
Cost of sales		\$ 60
Inventory		\$ 40

Consistent with Example CG 8-1 and Example CG 8-2, this adjustment is necessary as the sellers' pre-tax profit is deferred in consolidation, and the asset is carried at its cost to the seller until it is sold to an unrelated third party.

To reverse the write-down of inventory recorded by Company B by recognizing intercompany profit to the extent of the write-down of \$30:

Dr. Inventory	\$ 30	
Cr. Cost of sales		\$ 30

This adjustment is necessary as the inventory balance in consolidation has already been adjusted to reflect the seller's cost basis of \$60, which is below the \$70 NRV for the inventory.

To defer profit equal to the NCI's share of the write-down (40% of \$30), which would otherwise be recognized in Company A's income:

Dr. Cost of sales	\$ 12	
Cr. Deferred income liability		\$ 12

This adjustment in effect recognizes the NCI's share of Company B's write-down in Company A's consolidated financial statements, and defers Company A's 60% share of the write-down (\$18), which would be recognized when Company B sells the inventory to a third party. Because Company B wrote down the inventory by \$30, and Company A's share of that write-down is \$18, Company A would recognize \$22 (\$40 - \$18) of profit if Company B were to sell its inventory to a third party.

A summary of the adjustments and resulting balances are shown below.

	Co A	Co B	Total	Adj 1	Adj 2	Total after Adj	Adj for NCI	Total Consol
Inventory	—	\$70	\$70	\$(40)	\$30	\$60	—	\$60
Deferred income liability	—	—	—	—	—	—	12	12
Sales	\$100	—	\$100	\$(100)	—	—	—	—
COGS	(60)	(30)	(90)	60	30	—	(12)	(12)
Pre-tax profit	\$40	\$(30)	\$10	\$(40)	\$30	—	(12)	\$(12)*

* The pre-tax loss of \$12 represents the amount attributable to NCI that must be charged to adjust the parent's share of the write-down. In Year 2, assume Company B sells all of the inventory at \$70, cost of sales would have to be reduced by the prior period's intercompany loss elimination, the effect of which would be attributed entirely to the controlling interest which would result in recognition of intercompany profit of \$22.

8.2.5.1 *Intercompany transactions at a loss*

Both ASC 810-10-45-1 and ASC 323-10-35-7 provide for elimination of intercompany losses (by increasing the carrying amount of the related assets) in a manner consistent with intercompany income. When accounting for intercompany inventory sales at a loss, a similar procedure as described in CG 8.2.4 should be followed, but special care must be exercised in making a lower of cost or net realizable value test of the inventories of the purchasing company. NRV must cover both the carrying amount reflected in the inventories as recorded in the books of the company holding the inventories, the related tax effects on the intercompany transactions (see TX 2.4.4), and the losses deferred (added to carrying amount) by consolidating entries. If NRV is exceeded after deferring the losses in the consolidating entries, the losses that would otherwise be deferred in consolidation should be reduced, and a corresponding adjustment made to the related tax effect, to reflect the NRV test determined at the consolidated level.

Intercompany losses should not be eliminated (deferred) if they represent a permanent loss of value of assets that should have been adjusted through lower of cost or net realizable value or other impairment models even if the assets had not been transferred to an affiliated company.

8.2.6 *Intercompany income on sales to regulated affiliates*

ASC 980-810-45-1 through ASC 980-810-45-2 provide that intercompany income arising from a sale by a nonregulated parent or affiliate to a regulated affiliate should not be eliminated if the sales price is reasonable and it is probable that, through the rate-making process, future revenue will approximate the sales price that will result from the regulated affiliate's use of the products. The sales price usually would be considered reasonable if it is accepted or not challenged by the regulator that governs the

regulated affiliate. Alternatively, the regulated utility should consider comparison to the return or pricing from other available sources.

8.3 *Joint venture versus collaborative arrangement – updated September 2023*

When an investor is evaluating whether it has entered into a joint venture arrangement, the investor should consider whether the arrangement is instead a collaborative arrangement. A collaboration arrangement is a series of contracts that cause entities to share economic risks and rewards, as defined in ASC 808.

Definition from ASC 808-10-20

Collaborative arrangement: A contractual arrangement that involves a joint operating activity. These arrangements involve two (or more) parties that meet both of the following requirements: (a) they are active participants in the activity and (b) they are exposed to significant risks and rewards dependent on the commercial success of the activity.

Entities may enter into arrangements to participate in a joint operating activity to develop and commercialize intellectual property (i.e., the development and commercialization of a new drug, software, computer hardware, or a motion picture). Collaborative arrangements in the scope of ASC 808 are usually executed through contracts, and are typically not conducted through a separate legal entity created by the sponsors specifically to perform the joint operating activity.

When a collaborative arrangement is conducted through a separate legal entity, the sponsors should evaluate whether joint venture accounting applies, as discussed in EM 6. In arrangements conducted through a separate legal entity, the sponsors would likely apply the equity method, as discussed in EM 1 to EM 4.

Sponsors are specifically prohibited from applying the equity method of accounting to collaborative arrangements in which a separate legal entity does not exist as per ASC 808-10-15-4. See RR 2.4.1 for additional information on collaborative arrangements.

New guidance

In August 2023, the FASB issued ASU 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*. The new guidance requires a joint venture to apply a new basis of accounting for all contributions received upon its formation. This accounting will largely be consistent with ASC 805, *Business Combinations*, with some specific exceptions (refer to EM 6.4.1). While ASU 2023-05 does not apply to collaborative arrangements in the scope of ASC 808, it does apply to parts of a collaborative arrangement that are conducted in a separate legal entity that meets the definition of a joint venture. The new guidance should be applied prospectively and is effective for all newly formed joint venture entities with a formation date on or after January 1, 2025. For joint venture entities formed before the effective date, an election can be made to apply the new guidance retrospectively if sufficient information is available to do so. Early adoption is permitted.

8.3.1 *Research and development arrangements*

Companies may enter into unique arrangements, such as R&D-focused partnerships, strategic alliances, and collaborations to fund research and development activities. When those arrangements do not involve a separate legal entity, but are structured through contractual arrangements whereby the entities actively participate in the research and development of a product and share the financial risks and rewards of the R&D efforts, the arrangement may qualify for accounting as a collaborative arrangement in accordance with ASC 808. The demand for new sources of capital has led many companies to explore innovative R&D funding arrangements. Often partners or investors may be financial or passive investors. If these investors are not actively participating in the R&D efforts, the investment would not be in scope of ASC 808 and the investors should assess whether the arrangement is within the scope of ASC 730-20, *Research and Development Arrangements*, or ASC 470-10-25, *Sales of Future Revenues*.

Arrangements between pharmaceutical companies (“Pharma”) and financial investors have become more prevalent in recent years. These arrangements tend to utilize one of the following strategies:

- **Direct R&D Funding:** This strategy is predicated on a financial investor providing direct funding to Pharma for specified R&D projects in return for future payments (e.g., milestone payments, royalties on sales) contingent upon successful completion of the R&D.
- **Newco R&D Funding:** This strategy involves a third party investor establishing a new entity to perform the R&D, which may be outsourced back to Pharma or to an unaffiliated contract research organization, often with a predetermined exit (e.g., providing Pharma a call option or contingent forward purchase) only upon successful completion of the R&D.

A company that actively participates in a direct R&D funding arrangement should look to ASC 808 to determine whether it has entered into a collaboration arrangement. The company may then need to consider accounting guidance per ASC 606, *Revenue from Contracts with Customers*, ASC 730, *Research and Development*, or ASC 470, *Debt*.

A company with an interest in a new entity that was created to facilitate an R&D funding arrangement should evaluate whether it is required to consolidate the entity under the guidance in ASC 810. See PPE 8.3.4 for additional information on R&D funding arrangements.

8.4 *Proportionate consolidation*

The term “proportionate consolidation” means presenting an investor’s pro-rata share of a venture’s assets and liabilities in each applicable line item of the investor’s balance sheet, and pro-rata results of a venture’s operations in each applicable line item in its income statement. This presentation may be used in two situations, if certain conditions are met.

- *Undivided interest*

In this situation, the investor does not have an ownership interest in a legal entity but rather has an undivided ownership interest in assets, and is proportionately liable for each liability. In this case, the reporting entity is outside of the scope of equity method accounting (ASC 323) and proportionate consolidation is appropriate, except as described in the following paragraph.

If the venture holds real estate assets subject to joint control, then the investment would be in the scope of ASC 323 due to the guidance in ASC 970-323-25-12 and proportionate presentation would be precluded. The presentation and disclosure requirements of ASC 323 would apply.

In the utilities industry, there are unique considerations for undivided interests predicated on an SEC Staff Accounting Bulletin that is further discussed in UP 15.

Also, as discussed in Chapter 3.02 of the AICPA Audit and Accounting Guide, Entities With Oil and Gas Producing Activities, ownership of oil and gas is usually through a mineral interest, which is an economic interest in underground minerals. Such an arrangement does not involve a separate legal entity, and each party holds an individual interest in the asset and is proportionately liable for any liabilities. As a result, these arrangements are accounted for using proportionate consolidation.

□ *Equity method in the construction and extractive industries*

In this situation, the investor has an ownership interest in an unincorporated legal entity. An investor that holds a noncontrolling ownership interest in an unincorporated legal entity in the construction or extractive industries that qualifies for the equity method of accounting may elect proportionate consolidation in accordance with ASC 810-10-45-14. This is the case even if another reporting entity consolidates the legal entity.

In determining whether a legal entity is an unincorporated entity, the reporting entity should consider the governance attributes and economic characteristics of the legal entity to determine whether it is more akin to a corporation or a partnership. For example, if the legal entity has governance attributes that are more representative of a corporation (e.g., a board of directors as opposed to a general partner or managing member), it generally would not be considered an unincorporated legal entity. For more information, see CG 7.1.1.

To qualify as an extractive industry, activities of the investee must be limited to extraction of mineral resources, such as oil and gas exploration and production. A reporting entity with a noncontrolling investment in an unincorporated legal entity engaged in activities such as refining, marketing, or transporting extracted mineral resources would not qualify to elect proportionate consolidation. In that case, the presentation and disclosure requirements of ASC 323 would apply.