



New Developments Summary

Step-by-step approach to applying the VIE consolidation model

Updated for ASU 2015-02, *Amendments to the Consolidation Analysis*

Summary

This publication updates NDS 2010-19, “Variable Interest Entity Analysis,” on applying the variable interest entity (VIE) consolidation model under ASC 810, as amended by ASU 2015-02, *Amendments to the Consolidation Analysis*, issued in February 2015. These amendments

- Modify the evaluation of whether limited partnerships and similar legal entities are VIEs or voting interest entities
- Eliminate the presumption that a general partner should consolidate a limited partnership
- Affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related-party relationships
- Provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply, or operate in accordance, with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds

Note that all blocks of italicized text that appear in this bulletin are taken directly from ASC 810, *Consolidation*, in the FASB Codification.

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Overview of the U.S. GAAP consolidation model

Under ASC 810, *Consolidation*, a reporting entity (that is, the entity issuing financial statements) should consolidate a separate legal entity when the reporting entity has a controlling financial interest in another separate legal entity. For many entities, a reporting entity that owns greater than 50 percent of a legal entity's voting equity has a controlling financial interest. However, certain legal entities are not controlled through the voting rights of their equity interests, but rather through other rights. Therefore, U.S. GAAP has two consolidation models to evaluate whether a reporting entity has a controlling financial interest in a separate legal entity: the *variable interest entity model* and the *voting interest entity model*. All reporting entities should first consider whether another legal entity should be consolidated under the variable interest entity (VIE) model and, if the VIE model does not apply, then should consider whether to consolidate the legal entity under the voting interest entity model. The terms "legal entity" and "entity" are used throughout this bulletin to refer to the entity being evaluated for consolidation.

Regarding what consolidation guidance should be applied by a reporting entity to a legal entity being analyzed for consolidation, the guidance in ASC 810-10-15-3 states that

All reporting entities shall apply the guidance in the Consolidation Topic to determine whether and how to consolidate another entity and apply the applicable Subsection as follows:

- a. If the reporting entity is within the scope of the Variable Interest Entities Subsections, it should first apply the guidance in those Subsections.*
- b. If the reporting entity has an investment in another entity that is not determined to be a VIE, the reporting entity should use the guidance in the General Subsections to determine whether that interest constitutes a controlling financial interest. Paragraph 810-10-15-8 states that the usual condition for a controlling financial interest is ownership of a majority voting interest, directly or indirectly, of more than 50 percent of the outstanding voting shares. Noncontrolling rights may prevent the owner of more than 50 percent of the voting shares from having a controlling financial interest.*
- c. If the reporting entity has a contractual management relationship with another entity that is not determined to be a VIE, the reporting entity should use the guidance in the Consolidation of Entities Controlled by Contract Subsections to determine whether the arrangement constitutes a controlling financial interest.*

The guidance in ASC 810 applies to all reporting entities, with specific qualifications and exceptions discussed in Step 4 below.

Besides the VIE consolidation model, U.S. GAAP provides for other consolidation models, including

- Voting interest model (ASC 810-10 or formerly Accounting Research Bulletin 51)
- Consolidation by contract (ASC 810-10 or formerly EITF Issue 97-2)
- Not-for-profit (ASC 810-958, *Not-for-Profit Entities*)

This bulletin focuses on the VIE model.

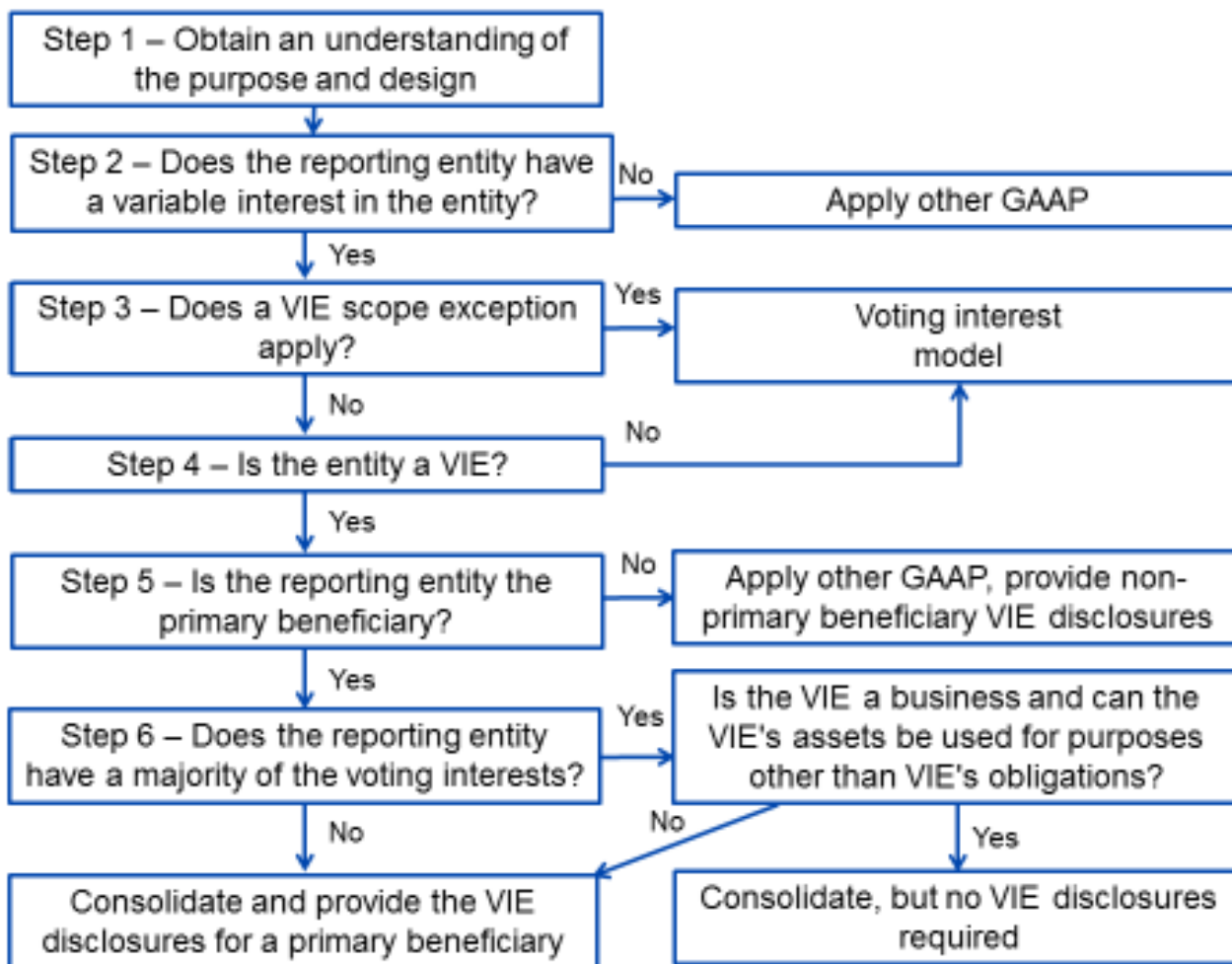
Note that all blocks of italicized text are taken verbatim from the guidance in ASC 810, *Consolidation*.

Applying the VIE consolidation guidance

U.S. GAAP requires consolidation by a reporting entity of a VIE when the reporting entity (a) has an economic interest in another legal entity (known as a “variable interest”) that conveys more than insignificant exposure to potential losses of or benefits from the other legal entity (the “economic” criteria), and (b) has power over the most significant economic activities of the legal entity (the “power” criteria). This consolidation model can be thought of as a “control” model (that is, which variable interest holder has power) as opposed to a “risk and rewards” model (that is, which variable interest holder is exposed to most of the economic risks and rewards). For many entities, a reporting entity that owns greater than 50 percent of a legal entity’s voting equity interests meets both the economic and power criteria. However, certain legal entities are not controlled through the voting rights of their equity interests, but rather through other rights, as further discussed below. Therefore, U.S. GAAP has two consolidation models to evaluate whether a reporting entity meets the economic and power criteria regarding a separate legal entity: the *variable interest entity* model and the *voting interest entity* model. This bulletin provides a step-by-step approach for applying the variable interest entity model.

The following table illustrates the overall U.S. GAAP consolidation model, with expanded guidance on the VIE model. It is important to note that all consolidation questions should start with a question of whether the reporting entity has a variable interest in a VIE. For example, a reporting entity’s 100 percent equity

ownership in a legal entity may represent a variable interest in a variable interest entity in which the VIE model rather than the voting interest model would apply.



Do I always need to apply the steps in the order suggested in this publication?

No. For example, Step 4 lays out various scope exceptions and may be applied before other steps. However, one likely would need to have a good understanding of the entity (Step 1) in order to apply certain scope exceptions, such as the “business scope exception” in ASC 810-10-15-17(d) that is discussed in Step 4.2.

Additionally, from a practical standpoint, certain reporting entities may not have enough information to apply the steps in order, or it may be difficult to determine whether the legal entity in which it has a variable interest is a VIE. However, such reporting entity may have enough information to conclude that it is not the primary beneficiary. If a reporting entity is able to determine that it is not the primary beneficiary, the determination of whether the legal entity to which it has a variable interest is a VIE only matters from a disclosure standpoint (that is, the disclosures in ASC 810-10-50-4 and 50-5A that apply to a reporting entity that holds a variable interest in a VIE, but is not the VIE’s primary beneficiary). As such, a reporting entity may determine if it is more practical to provide the disclosures required of a reporting entity that holds a variable interest in a VIE, but is not the VIE’s primary beneficiary, in lieu of definitively completing the VIE analysis.

While in some situations, not all steps need to be documented to reach an appropriate conclusion regarding the consolidation of a VIE, evaluating whether the reporting entity should consolidate another entity is a continuous analysis, and the steps not initially documented may become important in subsequent periods. Accordingly, it may be advisable to document key information about the purpose and design of the entity (see Step 1), as well as an identification of the activities that most significantly impact economic performance (see Step 6.2) regardless of the VIE conclusion, as this information may become essential if circumstances later change and a re-evaluation becomes necessary. For instance, if a reporting entity's right that had been protective is later triggered, effectively giving the reporting entity the power to direct or participate in certain decisions, an evaluation of whether the entity is a VIE or whether there has been a change in the primary beneficiary of a VIE might become necessary.

Is the 'pending content' in ASC 810-10 really pending?

For most reporting entities, the applicable guidance in ASC 810-10 is labeled "pending content," meaning that the content has been issued in a final ASU, but may not yet be effective for all entities. As such, it is important to carefully consider which version of a given paragraph applies.

If no pending guidance exists for a paragraph, the paragraph applies to all entities.

If pending guidance exists for a paragraph that references the transition guidance in ASC 810-10-65-7, the pending content applies to the amendments in ASU 2015-02, *Amendments to the Consolidation Analysis* (as amended by ASU 2016-17, *Interests Held through Related Parties That Are under Common Control*) that are effective for public business entities for fiscal years beginning after December 15, 2015. The guidance in ASU 2015-02 is effective for fiscal years beginning after December 15, 2016 for all other entities. ASU 2016-17 is effective at the same time as ASU 2015-02, with the same transition provisions. Entities electing to early adopt ASU 2015-02 that have not yet issued financial statements for the period of early adoption must simultaneously adopt ASU 2016-17.

Step 1 – Obtain and document an understanding of the purpose and design of the entity being evaluated for consolidation

Prior to beginning any consolidation analysis, the preparer of such analysis should obtain and document an understanding of the purpose and design of the legal entity being evaluated for consolidation, including the nature of the entity's risks and activities. Such analysis should consider all agreements and arrangements related to the legal entity, including relationships between the parties related to the legal entity. It may also be useful to consider other documents, such as marketing materials and term sheets.

The overall object of obtaining an understanding of the purpose and design of a legal entity is to provide a solid foundation for applying the consolidation literature, which is highly dependent on facts and circumstances.

Best practice tip in documenting an understanding of the legal entity's purpose and design

A diagram of a legal entity's arrangements, such as those illustrated in Cases A through H in ASC 810-10-55-59 through 55-86, can be a useful tool to help document the nature of arrangements and relationships considered in the consolidation analysis.

The following information provides general considerations to assist in obtaining and documenting an understanding of the purpose and design of the legal entity being evaluated for consolidation.

General questions to consider

Understanding the legal entity

- What does the entity do? What is its purpose?
- Who was involved in the design/structuring of the legal entity? Was one party more heavily involved in determining the design/structure of the entity and agreements/arrangements?
- What contractual agreements exist (for example, governing documents, loan agreements, management agreements, license agreements, purchase agreements, leases, or others)? What are the key terms of such agreements and are there any side agreements?
- What does each significant party to the arrangement do (that is, what is their business)? How does the legal entity relate to each party? Why did the parties get involved with the legal entity? What does each party bring to the table? What do the parties expect/hope to get out of the arrangement?
- Did any party transfer assets to the entity?
- Do the parties to the arrangement have previous relationships/agreements?
- Do the variable interest holders have agreements between one other? For example, has one equity holder made a loan to another equity holder to (directly or indirectly) fund its investment?
- Are the parties to the arrangement “related parties” as defined in ASC 850, *Related Party Disclosures*?
- Are the parties to the arrangement de facto agents or de facto principals pursuant to the guidance in ASC 810-10-25-43 (see later in this section under “When must a reporting entity consider related parties in applying the steps in this bulletin?”)?

Economics

- What is the ownership structure? Who owns what and how much?
- What are the terms of equity interests? What rights, obligations, and benefits does the equity interest entitle the equity holder to?
- What did each party contribute to the entity? In what form was the contribution (for example, debt, equity investment, commitment to provide future services, loans, land, buildings, and other assets)?
- Does the entity have debt? Who is the debt with (for example, one of the equity holders or a third-party lender)? What type of debt is it (for example, first mortgage loan vs. mezzanine loan)? What are the debt terms? Does anyone guarantee the debt? What type of guarantee is it (for example, is it a financial guarantee)?
- What is the “waterfall” for distributions (that is, do certain variable interest holders have preference over others regarding priority of distribution of cash from the entity)?

Rights of the parties involved with the entity

- What rights/powers does each party have (such rights may be held through equity interests or other agreements)?

- What is the governance of the entity? How do decisions get made? If there is a board, is the board active? Are there committees or task forces in which decisions are made?
- Does the entity have a general manager/president? Is the general manager/president from one of the variable interest holders? Who does the general manager/president report to?
- What are the legal entity's "major decisions" (that is, decisions that most significantly impact the economic performance of the legal entity)? How are those decisions made? See Step 6.1 for a more expansive discussion.
- Are there any put/call options? If so, what are the terms?
- Do any parties have kick-out/removal/liquidation rights in any agreements (including, for example, the management agreement)? If so, what are the terms? When can they be exercised (for example, for cause or unilaterally without cause)? See Step 5.2 for a more expansive discussion.
- What happens if the parties cannot agree? Arbitration? Buy/sell clause?
- Is any party considered the general partner, managing member, or equivalent? What rights do they have in such role?
- If there is a management or services agreement, what rights do the parties have under the agreement?

Substantive terms, transactions, and arrangements

The guidance in ASC 810-10-15-13A through 15-13B emphasizes that only substantive terms, transactions, and arrangements (both contractual and noncontractual) should be considered when evaluating a legal entity for consolidation. The FASB added this emphasis to address concerns that the form of an entity might indicate that it is not a VIE, or that a reporting entity is not the primary beneficiary, when the substance of the arrangement indicates otherwise.

SEC staff views on nonsubstantive terms

At the 2009 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff said it is aware of proposed structures designed to result in the deconsolidation of underperforming assets, including past due loans, securities, and real estate. A reporting entity may appear to have relinquished control of a proposed structure under the consolidation literature, perhaps by creating the appearance that power is shared, but in substance, the reporting entity has retained substantially all of the economic risks of ownership of the assets transferred. The staff indicated that the analysis of such arrangements warrants an increased level of skepticism.

The following examples from the SEC staff presented at the conference show how the substance of an arrangement might indicate that a reporting entity has retained control over a legal entity's significant activities, because the manager is acting as an agent of the reporting entity:

- A reporting entity transfers assets to a legal entity managed by a third party. However, the third-party manager holds minimal equity interest in the legal entity and that interest appears to be guaranteed by the management fee structure. Furthermore, the reporting entity can remove the manager if the manager's performance is unsatisfactory.
- A legal entity similar to the one described above includes a buy-sell clause rather than a removal right, but the third-party manager lacks the financial ability to exercise its rights under the buy-sell clause. This provision may be, in substance, a call option held by the reporting entity or the transferor.

In June 2010, Paul Beswick, Deputy Chief Accountant in the Office of the Chief Accountant of the SEC, spoke at the University of Southern California SEC and Financial Reporting Institute Conference on the use of judgment in applying to structured transactions the principles of Statement of Financial Accounting Standards 167, as codified in ASC 810. Mr. Beswick provided the following three examples of how he believes judgment should be applied to determine the substantive nature of a structured transaction, emphasizing the need for exercising professional skepticism in the application of the consolidation guidance:

- *The sale to third parties of some newer forms of notes that would absorb a majority of the structured entity's expected losses* – Mr. Beswick was skeptical that such notes could be a substantive indicator that the sponsor is acting simply as an agent or service provider when the sponsor is explicitly or implicitly obligated to support the structure in distressed circumstances.
- *The sale of unilateral kick-out rights to a third-party investor in a structured entity to avoid consolidation by the sponsor when the sponsor designed the structure and retains significant implicit or explicit residual risk in the structured entity* – Mr. Beswick expressed skepticism as to whether such kick-out rights could be considered substantive.
- *A structured entity designed with the appearance of shared power held by multiple unrelated parties in an effort to remove problem assets from a sponsoring entity's books when the sponsoring entity retains most of the downside risk* – Mr. Beswick stated that "A structure that permits deconsolidation without transferring substantive power merits extensive professional skepticism."

Mr. Beswick explained that the examples are intended to highlight the role of judgment in analyzing structured transactions. He noted that nonsubstantive terms of an arrangement should be disregarded when determining who makes the key decisions that most significantly impact an entity's economic performance (see Step 6.2). His speech is also intended to convey how serious the staff is about the development of practices that comply with the spirit of the VIE model.

When must a reporting entity consider related parties in applying the steps in this bulletin?

A reporting entity must consider related parties in applying the following guidance:

- The scope exceptions for not-for-profit entities and certain businesses (see Step 4.2)
- The identification of variable interests, such as implicit variable interests and fees paid to a decision maker or service provider (see Step 3)
- The determination of whether the entity is a VIE under ASC 810-10-15-14(c) (see Step 5)
- The determination of which party is the primary beneficiary of a VIE (see Step 6)

For purposes of applying the VIE model, the term "related parties" includes those parties identified as related parties in ASC 850, as well as de facto principals and de facto agents described in ASC 810-10-25-43 (see Step 6).

The ASC Glossary definition of "related parties" includes:

- Affiliates, including subsidiaries and commonly controlled entities
- Equity method investees
- Trusts for the benefit of employees, such as pensions and profit-sharing trusts that are managed by or under the trusteeship of management
- Principal owners

- Management
- Members of the immediate families of principal owners and management
- Other parties the reporting entity deals with if one party controls or can significantly influence the management or operating policies of the other party to the extent that one party may be prevented from fully pursuing its separate interests
- Another party that either (1) can significantly influence the management or operating policies of the transacting parties, or (2) has an ownership interest in one of the transacting parties and can significantly influence the other to the extent that a transacting party may be prevented from fully pursuing its separate interests

De facto agents are a party that is not otherwise a related party of the reporting entity, but is compelled to act on the reporting entity's behalf. De facto agents identified in ASC 810-10-25-43 include

- A party that cannot finance its operations without subordinated financial support from the reporting entity (ASC 810-10-25-43(a))
- A party that received its interests in the entity as a contribution or loan from the reporting entity (ASC 810-10-25-43(b))
- An officer, employee, or member of the reporting entity's governing board (ASC 810-10-25-43(c))
- A party whose ability to manage the economic risks or rewards from its interests in a VIE is constrained by the reporting entity's prior-approval right for the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship is not created by both the reporting entity and the party holding prior-approval rights that are based on mutually agreed terms by willing, independent parties (ASC 810-10-25-43(d)).
- A party that has a close business relationship, such as the relationship between a professional service provider and one of its significant clients (ASC 810-10-25-43(e))

Now that I have identified the rights of the parties, do I need to evaluate whether such rights are power, participating rights, or protective rights?

The evaluation of such rights is important in determining (1) whether the legal entity being evaluated for consolidation is a VIE according to the condition in ASC 810-10-15-14(b)(1) (power is not held by equity holders as a group, discussed in Step 5.2), and (2) who meets the power condition in ASC 810-10-25-38A(a) (discussed in Step 6.2). A reporting entity could choose to make the evaluation now, or wait until it gets to Steps 5.2 and 6.2.

What are the differences between kick-out, participating, and protective rights?

The answer to those question depends on whether a reporting entity is evaluating a legal entity for consolidation pursuant to the voting interest entity model or the variable interest entity model.

For purposes of evaluating investees pursuant to the voting interest entity model, the definitions in the following table, found in ASC 810-10-20, should be used.

Voting interest entity model of consolidation	
Terms	Definitions
Kick-out rights	The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause
Participating rights	Rights that 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.
Protective rights	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

For purposes of evaluating a legal entity pursuant to the VIE model, the following definitions, also found in ASC 810-10-20, should be used.

Variable interest entity model of consolidation	
Terms	Definitions
Kick-out rights	The ability to remove the entity with the power to direct the activities that most significantly affect a VIE's (or potential VIE's) economic performance or to dissolve (liquidate) the VIE without cause
Participating rights	The ability to block or participate in the actions through which an entity exercises the power to direct the activities that most significantly impact a VIE's (or potential VIE's) economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Protective rights	Rights that, if held by others, do not prevent a reporting entity from having the power to direct the activities that most significantly impact a VIE's economic performance
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The definitions in the two previous tables should not be used for any analysis other than the application of the guidance in ASC 810-10.

Are kick-out rights substantive?

When evaluating whether a limited partnership or similar entity provides partners with substantive kick-out rights over the general partner, and whether it therefore should be evaluated for consolidation under the voting interest entity model (see Step 5.2), reporting entities should evaluate whether such kick-out rights are substantive by considering the guidance in ASC 810-10-25-14A through 25-14C and then further considering the guidance in ASC 810-10-55-4N through 55-4W.

For entities subject to the VIE model, substantive kick-out rights, if exercisable only by a single party and its related parties and de facto agents, should be considered when determining whether an entity is a VIE and when identifying the primary beneficiary of a VIE.

The VIE guidance in ASC 810 does not provide specific guidance on determining whether kick-out rights are substantive. Previously, FASB Interpretation (FIN) 46 (revised December 2003), *Consolidation of Variable Interest Entities*, provided guidance in evaluating whether kick-out rights are substantive; however, such guidance was eliminated by ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. We believe that prior to the effective date of ASU 2015-02, the guidance in ASC 810-20-25-8 could be used as a starting point in evaluating whether kick-out rights are substantive, but that guidance should not be considered all-inclusive. Whether kick-out rights are substantive will continue to be a matter of professional judgment.

Deletion of substantive kick-out rights guidance

ASU 2015-02 supersedes the guidance in ASC 810-20-25-8 related to determining whether kick-out rights held by limited partners (or similar parties) are substantive. However, we believe such guidance would continue to be helpful when evaluating whether such kick-out rights are substantive.

Those superseded paragraphs and text moved from ASC 810-20-25-8 are presented below:

The determination of whether the kick-out rights are substantive shall be based on a consideration of all relevant facts and circumstances. Substantive kick-out rights shall have both of the following characteristics:

- a. *[note: subparagraph deleted by ASU 2015-02] The kick-out rights can be exercised by a single limited partner or a vote of a simple majority or a lower percentage of the limited partners' voting interests held by parties other than the general partner, entities under common control with the general partners or a general partner, and other parties acting on behalf of the general partners or a general partner. A kick-out right that contractually requires a vote in excess of a simple majority (such as a supermajority) of the limited partners' voting interests to remove the general partners may still be substantive if the general partners could be removed in every possible voting scenario in which a simple*

majority of the limited partners' voting interests vote for removal. That is, there is no combination of the limited partners' voting interests that cannot remove the general partners. All relevant facts and circumstances shall be considered in assessing whether other parties, including, but not limited to, those defined as related parties in Topic 850, may be acting on behalf of the general partners in exercising their voting rights as limited partners. Similarly, in assessing whether a single limited partner has the ability to remove the general partners, consideration shall be given to whether other parties, including, but not limited to, those defined as related parties in that Topic, may be acting with the limited partner in exercising their kick-out rights

- b. *[note: this text moved to ASC 810-10-25-14A by ASU 2015-02] The limited partners holding the kick-out rights have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of those rights. Barriers include, but are not limited to:*
1. *Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of exercise*
 2. *Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution or removal*
 3. *The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement*
 4. *The absence of an explicit, reasonable mechanism in the limited partnership agreement or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights*
 5. *The inability of the limited partners holding the rights to obtain the information necessary to exercise them*

How should rights be evaluated to determine if they are participating rights?

Identifying the activities that most significantly impact a legal entity's economic performance is often the most critical consideration in evaluating consolidation, and identifying those activities is a prerequisite to determine if rights held by the reporting entity are participating rights.

When evaluating whether rights held by the reporting entity are participating rights, it is important to consider at which level within the entity that the decisions about those activities are made. For instance, are those decisions made at a board level, by management, or through contractual arrangements? To be considered substantive participating rights within the VIE guidance, those rights must relate directly to the activities that most significantly impact economic performance.

What are some examples of protective rights?

The following rights may be protective rights if they are designed to protect the interest of the party holding the rights, without giving that party a controlling financial interest in the legal entity to which they relate:

- A franchise agreement that restricts a franchisee’s activities to protect the franchise brand, without giving the franchisor a controlling financial interest in the franchisee. Such limitations on the operating activities of an entity would be considered protective rights.
- Approval or veto rights that apply only in exceptional circumstances and do not affect the activities that most significantly impact the legal entity’s economic performance, such as
 - The right to approve capital expenditures above a set amount or to approve the issuance of debt or equity interests
 - A lender’s right to approve the sale of important assets or to undertake activities that change the borrower’s credit risk

However, rights initially determined to be protective could result in the holder obtaining the power to direct the activities of the entity at a later date, for example, a lender’s contractual right to direct the most significant activities of an operating entity in the event of a default on the loan.

Step 2 – Determine whether the entity being evaluated for consolidation is a legal entity

The VIE guidance only applies to legal entities, as defined in ASC 810-10-20. Therefore, it is important to determine whether the entity being evaluated for consolidation is a legal entity. Examples of legal entities include, but are not limited to,

- Corporations, including S corporations
- Limited liability companies
- Partnerships, including limited partnerships and master limited partnerships
- Trusts

Step 3 – Determine the variable interests in the legal entity being evaluated for consolidation

A “variable interest” is an interest in a legal entity that will absorb expected losses or receive residual returns from the entity. Assessing whether a reporting entity’s investments in, and arrangements with, a legal entity represent variable interests is critical for many reasons. If a reporting entity does not have a direct or indirect (explicit or implicit) variable interest in a legal entity, then the reporting entity is not the primary beneficiary of that legal entity. In addition, the reporting entity is not required to provide the VIE disclosures for that legal entity. Therefore, a reporting entity should determine, as early as possible in the analysis, if it has a variable interest(s) in a legal entity to determine whether any further assessment of that legal entity is necessary under the VIE model.

Identifying variable interests

What does GAAP say

The guidance in ASC 810-10-20 provides the following definitions to help reporting entities assess whether their investments in, and arrangements with, a legal entity constitute “variable interests”:

Variable Interests – *The investments or other interests that will absorb portions of a variable interest entity’s (VIE’s) expected losses or receive portions of the entity’s expected residual returns are called variable interests. Variable interests in a VIE are contractual, ownership, or other pecuniary interests*

in a VIE that change with changes in the fair value of the VIE's net assets exclusive of variable interests. Equity interests with or without voting rights are considered variable interests if the legal entity is a VIE and to the extent that the investment is at risk as described in paragraph 810-10-15-14. Paragraph 810-10-25-55 explains how to determine whether a variable interest in specified assets of a legal entity is a variable interest in the entity. Paragraphs 810-10-55-16 through 55-41 describe various types of variable interests and explain in general how they may affect the determination of the primary beneficiary of a VIE.

Expected Losses – *A legal entity that has no history of net losses and expects to continue to be profitable in the foreseeable future can be a variable interest entity (VIE). A legal entity that expects to be profitable will have expected losses. A VIE's expected losses are the expected negative variability in the fair value of its net assets exclusive of variable interests and not the anticipated amount or variability of the net income or loss.*

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

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

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

What are common variable interests?

Variable interests could include, but are not limited to, the following items:

- Equity interests
- Contractual arrangements that create potential variable interests, including, but not limited to
 - Loans and other debt instruments issued by the legal entity
 - Leasing arrangements
 - Residual guarantees and purchase options at specified prices
 - Obligations that protect holders of variable interests, such as
 - Guarantees of the value of the legal entity's assets or liabilities
 - Written put options on the legal entity's assets
 - Commitments to provide liquidity
 - Agreements to replace the legal entity's impaired assets

- Fees paid to a decision maker or service provider (see additional guidance below under “How management and service agreements are evaluated to determine whether they are variable interests”)
 - Some supply or purchase contracts
 - Franchise arrangements
 - Put options
 - Forward contracts to sell the legal entity’s assets
 - Total return swaps issued by the legal entity
 - Swaps and other freestanding derivatives
- Embedded derivatives that are not clearly and closely related to their asset or liability host contract

What is an ‘implicit’ variable interest?

An “implicit” variable interest is an implied pecuniary interest in a legal entity that acts the same as an explicit variable interest; in other words, the interest absorbs or receives the legal entity’s variability. An implicit variable interest can 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.

For example, a reporting entity may not have an explicit obligation to guarantee a legal entity’s debt, but an implicit guarantee may exist if the reporting entity could be required to provide, or if there is an incentive for it to provide, financial support to the legal entity. A common example of an arrangement that may contain implicit variable interests is a lease between entities under common control (see the discussion of a common-control leasing arrangement in Appendix E). Certain private companies with common-control leasing arrangements may be eligible for an accounting alternative to applying the VIE guidance under ASC 810-10-15-17A through 15-17C (see Appendix E for further discussion).

The SEC staff has highlighted the need to consider activities “around the entity” when identifying potential variable interests, such as transactions between variable interest holders in a variable interest entity. Such activities can also affect the assessment of whether an entity is a VIE, as well as which reporting entity is the primary beneficiary. In a 2004 speech at the AICPA National Conference on SEC and PCAOB Developments, Jane D. Poulin, Associate Chief Accountant, gave the following example of an “activity around the entity” that should be considered when evaluating whether a reporting entity has a variable interest in a legal entity:

Say a company (Investor A) made an equity investment in a potential VIE and Investor A separately made a loan with full recourse to another variable interest holder (Investor B). We have been asked whether the loan in this situation can be ignored when analyzing the application of [ASC 810]. The short answer is no. First, [ASC 810] specifically requires you to consider loans between investors as well as those between the [legal] entity and the [reporting entity] in determining whether equity investments are at risk, and whether the at-risk holders possess the characteristics of a controlling financial interest as defined in [ASC 810]. It is often difficult to determine the substance of a lending relationship and its impact on a VIE analysis on its face. You need to evaluate the substance of the facts and circumstances. The presence of a loan between investors will bring into question, in this example, whether Investor B’s investment is at risk and, depending on B’s ownership percentage and voting rights, will influence whether the at-risk equity holders possess the characteristics of a controlling financial interest.

Other examples of activities or arrangements that may give rise to implicit variable interests include

- Puts and calls between the reporting entity and other investors and noninvestors in the legal entity
- Service arrangements with investors and noninvestors
- Derivatives such as total return swaps
- Tax credits generated from the legal entity's business that are available to investors. If investors become involved with an entity because of the availability of tax credits generated from the entity's business, the SEC staff has historically objected if the investor did not include the tax credits both (1) as a component of the investor's variable interest in the entity, and (2) as a component of expected loss and expected residual return in the investor's consolidation analysis.

The SEC staff has also emphasized that a company could have an implicit variable interest in a VIE despite having no direct contractual interest in that entity. Evaluating whether an implicit variable interest exists is a matter of judgment. The following list of questions/factors should be considered in determining whether a reporting entity has an implicit variable interest in the legal entity being evaluated:

- Has the reporting entity previously provided financial support to the legal entity or in similar situations in the past?
- Could a party require the reporting entity to provide financial support?
- Does the reporting entity have any incentive to provide financial support to the legal entity? Indicators that a reporting entity may have an incentive to provide financial support to the legal entity, include, but are not limited to, the following considerations:
 - The reporting entity is a related party of other variable interest holders of the legal entity.
 - The legal entity was designed to protect the equity investors from absorbing significant variability.
 - There are economic incentives for the reporting entity to act as a guarantor or to make funds available to the legal entity.
 - There are consequences to the reporting entity if it does not provide financial support to the legal entity should it be required. For example, this may be the case if the legal entity is a major supplier of the reporting entity, and the reporting entity has a difficult time obtaining the product from other suppliers.
- Does the reporting entity have any impediments in providing financial support to the legal entity? Indicators that the reporting entity may be impeded in providing financial support to the legal entity include, but are not limited to, the following criteria:
 - The reporting entity has debt covenants or clauses in other contractual arrangements that would prohibit providing financial support.
 - The reporting entity does not have the wherewithal to provide financial support.
 - Providing support would be considered a conflict of interest or illegal.

Do I always need to identify every variable interest?

No. The primary relevance of determining whether agreements/arrangements represent variable interests in applying the VIE model are as follows:

- If the reporting entity has no variable interests in the legal entity being evaluated, the VIE model does not apply. If the reporting entity has a variable interest(s) in the legal entity being evaluated for consolidation, further analysis is required.
- If the reporting entity has variable interest(s) in the legal entity being evaluated and the legal entity is determined to be a VIE, further analysis is required to determine whether the reporting entity meets the second condition of a primary beneficiary (see Step 6).

We do not believe it is always necessary to evaluate all agreements/arrangements to determine whether they are variable interests. For example, a reporting entity may provide a financial guarantee on the legal entity's debt. The reporting entity may be able to conclude that such a guarantee is a variable interest if, as a result of the guarantee, the legal entity being evaluated for consolidation is a VIE under ASC 810-10-15-14(a) (total equity at risk is insufficient). As such, while the reporting entity may have other agreements/arrangements that are potential variable interests, it may not be necessary to definitively conclude that they are indeed variable interests. However, such other agreements/arrangements must be considered in applying the VIE model, including whether it gives the reporting entity the power to direct the most significant activities of a VIE (irrespective of whether the other agreements are indeed a variable interest) and for disclosure purposes under ASC 810-10-50-5A(d).

Are expected losses, expected residual returns, and expected variability amounts reported in an entity's financial statements?

No. Expected losses, expected residual returns, and expected variability are not amounts reported in an entity's financial statements (meaning that the terms do not refer to net losses or net income); rather, they are economic concepts used to identify variable interests and VIEs. A calculation of a legal entity's expected losses and expected residual returns might be necessary to determine whether a legal entity is a VIE, but not to determine the primary beneficiary of a VIE.

The examples in ASC 810-10-55-42 through 55-54 illustrate the calculation of expected losses and expected residual returns.

For example, the estimated current fair value of a building owned by an entity represents the return expected if the building were sold today. However, the building's actual price if sold may be more or less than expected, which would cause the entity's return to vary from the expected amount. As a result, ownership of the building creates variability in that entity because the variability in the returns to the entity from the building's sale would correspondingly affect returns to holders of variable interests in that entity.

How should one go about determining variability of an entity?

The guidance in ASC 810-10-25-21 through 25-36 specifically requires that the determination of variability must be based on an analysis of the design of the legal entity, as outlined in the following two steps:

- *First step:* Analyze the nature of the risks that cause variability in the legal entity. Such risks may include, but are not limited to, the following:
 - Credit risk
 - Interest-rate risk (including prepayment risk)
 - Foreign-currency exchange risk
 - Commodity price risk
 - Equity price risk
 - Operations risk

- *Second step:* Determine the purpose(s) for which the legal entity was created and the variability (created by the risks identified in the first step) that the legal entity is designed to create and pass along to its interest holders, taking into consideration the following factors:
 - The activities of the legal entity
 - The terms of the contracts the legal entity has entered into
 - The nature of the legal entity's interests issued
 - How the legal entity's interests were negotiated with, or marketed to, potential investors
 - Which parties participated significantly in the design or redesign of the legal entity

How management and service agreements are evaluated to determine whether they are variable interests

What does GAAP say

ASC 810-10-55-37 contains the following guidance regarding whether a management or service arrangement comprises a variable interest in a legal entity:

Fees paid to a legal entity's decision maker(s) or service provider(s) are not variable interests if all of the following conditions are met:

- a. *The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.*
- b. *Superseded by ASU 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. *Superseded by ASU 2015-02.*
- f. *Superseded by ASU 2015-02.*

In addition, the following guidance in ASC 810-10-55-37B through 55-38 provides additional guidance in determining when a fee paid to a decision maker is a variable interest:

Facts and circumstances should be considered when assessing the conditions in paragraph 810-10-55-37. An arrangement that is designed in a manner such that the fee is inconsistent with the decision maker's or service provider's role or the type of service would not meet those conditions. To assess whether a fee meets those conditions, a reporting entity may need to analyze similar arrangements among parties outside the relationship being evaluated. However, a fee would not presumptively fail those conditions if similar service arrangements did not exist in the following circumstances:

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

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

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.

ASC 810-10-55-37D –

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

ASC 810-10-55-38 –

Fees paid to decision makers or service providers that do not meet all of the conditions in the preceding paragraph are variable interests.

For examples of analyzing fees paid to decision makers pursuant to this guidance, see the investment fund and securitization examples in Appendix F.

Determining whether fees paid to a decision maker or servicer provider are not a variable interest

The guidance in ASC 810-10-55-37 and in 55-37B–55-37C provides various criteria that must be evaluated to determine whether fees paid to a legal entity’s decision maker(s) or service provider(s) are not variable interests. In evaluating this guidance, we often recommend that a reporting entity first evaluate whether it holds other interests in the VIE that individually, or in aggregate, would absorb more than an insignificant amount of the VIE’s expected losses or would receive more than an insignificant amount of the VIE’s expected residual returns. Of the three conditions necessary for a fee arrangement with a service provider not to constitute a variable interest in ASC 810-10-55-37, this condition is more likely than the other two to cause the management/service agreement to be a variable interest. If a reporting entity is unable to meet this condition, the management/service agreement would be a variable interest, and the other conditions in ASC 810-10-55-37 would not need to be evaluated, as such evaluation would not change the conclusion that the management/service agreement is a variable interest.

For a discussion of how this analysis is impacted by interests held by related parties, see Appendix C.

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.

Paragraph 37B addresses how to evaluate whether a fee that is compensation for services provided is commensurate with the level of effort required to provide those services. One of the practical implications of this paragraph regarding fees paid to decision makers or service providers is that incentive/management fees commonly paid to the general partner of an investment partnership will be evaluated as fee arrangements, rather than as part of the general partner’s ownership interest. However, after an incentive fee is earned, it would be considered part of the general partner’s ownership interest in the entity until the fee is paid.

Considering fees in context of the ‘economics’ criteria in ASC 810-10-25-38A(b)

Fees paid to a reporting entity by a VIE are excluded from evaluating the “economics” criteria in ASC 810-10-25-38A(b) if the fees are both (a) compensation for services provided, commensurate with the level of effort, and (b) their terms, conditions, and amounts are commensurate with fees customarily present in arrangements for similar services negotiated at arm’s length. The exception to this exclusion is when the fee exposes the reporting entity to a risk of loss, such as with fees for providing a guarantee or other similar “stand ready” obligations.

As a result of this guidance, customary (meaning market rate) fees paid for services provided that do not expose the reporting entity to a risk of loss do not, by themselves, cause a reporting entity to meet the economics criteria. Rather, to meet the economics criteria, the reporting entity would have to have other interests in the legal entity (including interests held by related parties, which would be considered on an indirect and proportionate basis) that expose the reporting entity to more than insignificant variability.

The guidance below describes when fees paid to decision makers are excluded from evaluating if a reporting entity meets the “economics” criteria for purposes of determining the primary beneficiary:

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*

ASC 810-10-25-38I –

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

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

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

ASC 810-10-25-38J –

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

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

Could I have a variable interest in only specified assets of a VIE (commonly referred to as “silos”)?

Yes. However, in practice, this is rare. Generally, variable interests are variable interests in the legal entity.

Consider the following guidance on variable interests in specific assets of a legal entity in ASC 810-10-25-55 through 25-58:

- A variable interest in specified assets of a VIE is a variable interest in the VIE only if (1) the specified assets' fair value is more than half the total fair value of the VIE's assets, or (2) the holder has another variable interest in the VIE as a whole.

- A reporting entity with a variable interest in specified assets of a VIE accounts for a portion of the VIE as a separate VIE, or “silo,” only if the specified assets of that portion are essentially the only source of payment for specified liabilities or specified other interests.

A potential variable interest may be an interest in only certain assets of a legal entity rather than an interest in all of the legal entity’s assets. For example, a reporting entity guaranteeing the residual value of a legal entity’s warehouse would have a potential variable interest in a specified asset of the legal entity (the warehouse). In contrast, if the reporting entity holds an equity investment at risk in the legal entity, it would have a variable interest in all of the legal entity’s assets.

If a reporting entity has variable interests in multiple specified assets (for example, residual value guarantees on a legal entity’s equipment and on its warehouse), the fair value of the specified assets (the equipment and the warehouse) should be aggregated to determine if the specified assets represent more than 50 percent of the total fair value of the legal entity’s assets. Also, to determine whether the reporting entity’s interests in specified assets are variable interests in the legal entity as a whole, the reporting entity should aggregate its variable interests with those of others in its related party group.

If the variable interest in specified assets is not considered a variable interest in the entity as a whole, expected losses that would be absorbed by that variable interest in specified assets (such as the guarantee of the residual value), as well as expected residual returns applicable to the variable interest in the specified assets, should not be considered

- As part of the expected losses of the legal entity that holds those assets in determining the adequacy of the legal entity’s equity investment at risk when analyzing whether the entity is a VIE
- For purposes of identifying the VIE’s primary beneficiary

A potential variable interest in specified assets should be analyzed to determine whether the specified assets and related specified liabilities form a separate VIE (a silo) apart from the legal entity in which they reside (the host entity). A silo is created and accounted for as a separate VIE only if both of the following conditions apply:

- The specified assets are essentially the only source of payment for specified liabilities or specified other interests.
- The host entity is a VIE.

The guidance in ASC 810-10-25-58 provides that a specified asset and a related specified liability secured only by the specified asset do not constitute a separate VIE if other parties have rights or obligations related to either the specified asset or its residual cash flows. To qualify as a silo, essentially all of the assets, liabilities, and equity of the deemed silo must be both separate from the overall legal entity and specifically identifiable.

According to the guidance in ASC 810-10-25-57, “[I]f 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.”

Step 4 – Determine whether the reporting entity qualifies for any scope exceptions or is a private company that qualifies for the accounting alternate to the VIE guidance for common-control leasing arrangements

The purpose of Step 4 is to evaluate whether the reporting entity qualifies for any available scope exceptions, including the accounting alternative available to private companies in applying the VIE

guidance to common-control leasing arrangements. The scope exceptions have been broken out into sub-steps.

Step 4.1 – Does the reporting entity qualify for any scope exceptions applicable to the overall consolidation model (ASC 810-10-15-12)?

The guidance in ASC 810-10-15-12 provides the following exceptions to consolidation that apply to both VIEs and voting interest entities:

- a. *An employer shall not consolidate an employee benefit plan subject to the provisions of Topic 712 or 715.*
- b. *[Subparagraph superseded by Accounting Standards Update No. 2009-16]*
- c. *[Subparagraph superseded by Accounting Standards Update No. 2009-16]*
- d. *Except as discussed in paragraph 946-810-45-3, an investment company within the scope of Topic 946 shall not consolidate an investee that is not an investment company.*
- e. *A reporting entity shall not consolidate a governmental organization and shall not consolidate a financing entity established by a governmental organization unless the financing entity meets both of the following conditions:*
 1. *Is not a governmental organization*
 2. *Is used by the business entity in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entities Subsections.*

Step 4.2 – Does the reporting entity qualify for any scope exceptions applicable to the variable interest consolidation model (ASC 810-10-15-17)?

The guidance in ASC 810-10-15-17 exempts the following entities from consolidation under the VIE model, but these entities may be subject to consolidation under other U.S. GAAP guidance:

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

This inability to obtain the necessary information is expected to be infrequent, especially if the reporting entity participated significantly in the design or redesign of the legal entity. The scope

exception in this provision applies only as long as the reporting entity continues to be unable to obtain the necessary information. Paragraphs 810-10-50-6 (for a nonpublic entity) and 810-10-50-16 (for a public entity) require certain disclosures to be made about interests in legal entities 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 legal entity subject to this exception.

- d. *A legal entity that is deemed to be a business need not be evaluated by a reporting entity to determine if the legal entity is a VIE under the requirements of the Variable Interest Entities Subsections unless any of the following conditions exist (however, for legal entities that are excluded by this provision, other generally accepted accounting principles [GAAP] should be applied):*
- 1. The reporting entity, its related parties (all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d)(1)), 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).

Does the scope exception in ASC 810-10-15-17(c) provide an indefinite deferral once met?

No. ASC 810-10-15-17(c) provides an exception for legal entities created before December 31, 2003 for which the reporting entity lacks sufficient information to apply the guidance on VIEs. This exception ceases to apply when the reporting entity obtains the necessary information. As such, a reporting entity should continue to make exhaustive efforts to obtain the information.

Additional guidance in applying the business scope exception (ASC 810-10-15-17(d))

Why did the FASB include a business scope exception?

The purpose of the business scope exception is to identify entities for which the reporting entity likely would not end up being the party that consolidates the legal entity, even if the legal entity is determined to be a VIE.

Does each reporting entity need to do a separate evaluation?

Yes. Most of the business scope exceptions focus on analyzing the relationships between the reporting entity and the legal entity being evaluated for consolidation. For example, if two reporting entities have variable interests in a potential VIE, it is possible for one reporting entity to meet the business scope exception and the other reporting entity not to meet the business scope exception.

If the legal entity being evaluated for consolidation is a business, does the reporting entity automatically qualify for the scope exception?

No. The fact that the legal entity being evaluated for consolidation is a business is only one of five factors that must be met in order to meet the business scope exception in ASC 810-10-15-17d. Therefore, an assumption that the VIE literature does not apply simply because the entity being evaluated for consolidation is a business, is not appropriate.

What should one consider in evaluating whether the reporting entity and/or its related parties (excluding de facto agents) participated significantly in the design or redesign of the legal entity?

In our view, in evaluating whether the reporting entity and/or its related parties (excluding de facto agents) participated significantly in the design or redesign of the legal entity, the reporting entity should consider the following factors:

- Whether the reporting entity transferred assets to the legal entity
- Role in capitalizing the entity through debt, equity, or other means
- Role in determining the governance of the entity
- Role in structuring the arrangement
- Role in the ongoing activities of the entity

There are no “bright lines” when evaluating whether a reporting entity played a significant role in the design of the legal entity. Rather, all facts and circumstances should be considered.

Are all joint ventures automatically scoped out of the VIE literature?

No. The joint venture scope exception in ASC 810-10-15-17(d)(1) only applies in evaluating one of the five conditions that must be met to qualify for the business scope exception. It is important to emphasize that the FASB has utilized the words “[an] operating joint venture under joint control of the reporting entity and one or more independent parties” to describe the joint ventures that may fall into this exception. As a result, for an entity to be under joint control, all key decisions of the entity must be subject to unanimous consent of the joint venture parties. In evaluating what constitutes the key decisions of a potential VIE, we believe that activities identified as those that would most significantly impact the VIE’s economic performance (consistent with those activities listed in ASC 810-10-25-38A) should be considered.

In evaluating whether the entity is designed so that substantially all of its activities either involve, or are conducted on behalf of, the reporting entity and its related parties, should the analysis be based on the reporting entity’s obligation to absorb expected losses or right to receive expected residual returns?

No. While the obligation to absorb substantially all of an entity’s expected losses, or the right to receive substantially all of an entity’s expected residual returns, might be a strong indicator that this condition is met, it should not be the only factor to consider. It is important to consider the purpose and design of the entity, including the risks the entity was designed to create and pass along. Also, activities that involve or are conducted on behalf of the reporting enterprise should be considered broadly from a qualitative perspective. For instance, sales between the reporting enterprise and the legal entity, as well as the relative importance of the sales, should be considered. Services performed by the legal entity for the reporting enterprise, as well as services performed by the reporting enterprise for the legal entity, should be considered, in addition to the relative importance of those services.

In evaluating whether the reporting entity and its related parties do not provide more than half of the total of equity, subordinated debt, and other subordinated financial support to the legal entity based on the fair values of the interests in the legal entity, what are some examples of “other subordinated financial support”?

The most common forms of “other subordinated financial support” consist of guarantees and agreements or arrangements to provide goods or services at terms that are not market terms or in exchange for the right to participate in future expected residual returns (or future “upside”) of the entity. Examples of other subordinated financial support include, but are not limited to, the following examples:

- A reporting entity enters into a long-term purchase or sale commitments at terms that are other than market terms.
- A reporting entity does not get paid for services performed, but rather is solely entitled to “upside” from performing such services (also known as “sweat equity”).

Step 5 – Determine whether the legal entity being evaluated for consolidation is a VIE

An entity is a VIE if it meets either of the following conditions as of the assessment date:

- The entity has insufficient equity, meaning it cannot sustain its activities on its own (see Step 5.1 or ASC 810-10-15-14(a)).
- The holders of an equity investment (as a group) at risk do not have the rights, benefits, and obligations consistent with those of equity holders (see Step 5.2 or ASC 810-10-15-14(b)).

Additionally, ASC 810 includes an “an anti-abuse clause” designed to prevent avoidance of consolidation of a legal entity by structuring the legal entity with nonsubstantive voting rights (see Step 5.3 or ASC 810-10-15-14(c)).

As of what date should a reporting entity assess whether the legal entity in which it has a variable interest is a VIE?

A reporting entity must assess whether the legal entity is a VIE as of the date of the reporting entity’s initial involvement with it and subsequently as of the date when a reconsideration events occur. The guidance in ASC 810-10-35-4 outlines the following reconsideration events:

- 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.*
- 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.*
- The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity’s expected losses.*
- The legal entity 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.*
- 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.*

An entity may not select a more convenient date for an assessment, such as the end of a reporting period. An assessment should include consideration of facts and circumstances that exist as of the assessment date, such as the date when the reporting entity initially becomes involved with the legal entity or a later reconsideration date. If financial information used in an assessment is as of a date that differs from the assessment date, for example, the end of a reporting period, then the reporting entity should adjust the financial information to reflect the impact of transactions and events that have occurred between the financial information date and the assessment date.

A legal entity that previously was not considered a VIE does not become a VIE simply because losses exceeding its expected losses reduce its equity investment. However, reconsideration of a legal entity's status may be required if such losses cause other changes, such as creating a default condition that, in substance, transfers power over the entity's most significant activities to the holder of the entity's debt.

Is it always necessary to evaluate each of the VIE conditions in ASC 810-10-15-14?

It is not necessary to evaluate each of the conditions if the entity is considered a VIE under one of the conditions. For example, if an entity concludes that the equity investment at risk is not sufficient and therefore the entity is a VIE under Step 5.1 (ASC 810-10-15-14(a)), it is not necessary to perform Step 5.2 or Step 5.3 (the other VIE conditions in ASC 810-10-15-14(b) or (c)), as such evaluation would not change the conclusion that the entity is a VIE.

From an efficiency standpoint, does it make sense to evaluate any of the VIE conditions first?

Yes. We believe it may be efficient to first evaluate whether the holders of the equity investment at risk lack any of three characteristics of a controlling financial interest (see Section 5.2 or ASC 810-10-15-14(b)(1)), because the analysis needed to evaluate this condition is similar to the evaluation of the "power" characteristic of a primary beneficiary, discussed in Steps 6.1 and 6.2. In other words, if you conclude that the entity is a VIE under ASC 810-10-15-14(b)(1), you will have a jump start on the analysis needed to evaluate who has power under ASC 810-10-25-38A(a).

Alternatively, based on an understanding of the entity obtained in Step 1, it may be clear that the legal entity's equity at risk is insufficient and, therefore, the entity is a VIE under ASC 810-10-15-14(a).

How should one approach evaluating whether an entity is a VIE?

It is important to emphasize that in evaluating whether a legal entity is a VIE, you are evaluating the legal entity. As such, the analysis must consider all agreements and arrangements of the legal entity, not just those between the reporting entity and the potential VIE. For example, if the reporting entity has only made an equity investment in a legal entity, but another party has provided a financial guarantee of the legal entity's debt, the legal entity would likely be considered a VIE because the presence of the guarantee suggests that the legal entity has insufficient equity at risk (as discussed in Step 5.1 below).

Step 5.1 – Insufficient equity (ASC 810-10-15-14(a))

What GAAP says

ASC 810-10-15-14(a) includes the following guidance regarding the first criteria in assessing whether a legal entity is a VIE, which is whether the legal entity has insufficient equity at risk:

The total equity investment (equity investments in a legal entity are interests that are required to be reported as equity in that entity's financial statements) at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. For this purpose, the total equity investment at risk has all of the following characteristics:

1. *Includes only equity investments in the legal entity that participate significantly in profits and losses even if those investments do not carry voting rights*
2. *Does not include equity interests that the legal entity issued in exchange for subordinated interests in other VIEs*
3. *Does not include amounts provided to the equity investor directly or indirectly by the legal entity or by other parties involved with the legal entity (for example, by fees, charitable contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor*
4. *Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the legal entity or by other parties involved with the legal entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.*

Paragraphs 810-10-25-45 through 25-47 discuss the amount of the total equity investment at risk that is necessary to permit a legal entity to finance its activities without additional subordinated financial support.

The following provides further explanatory guidance regarding whether a legal entity's equity at risk is insufficient:

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 legal entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient. The demonstration that equity is sufficient may be based on either qualitative analysis or quantitative analysis or a combination of both. Qualitative assessments, including, but not limited to, the qualitative assessments described in (a) and (b), will in some cases be conclusive in determining that the legal entity's equity at risk is sufficient. If, after diligent effort, a reasonable conclusion about the sufficiency of the legal entity's equity at risk cannot be reached based solely on qualitative considerations, the quantitative analyses implied by (c) shall be made. In instances in which neither a qualitative assessment nor a quantitative assessment, taken alone, is conclusive, the determination of whether the equity at risk is sufficient shall be based on a combination of qualitative and quantitative analyses.

- a. *The legal entity has demonstrated that it can finance its activities without additional subordinated financial support.*
- b. *The legal entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support.*
- c. *The amount of equity invested in the legal entity exceeds the estimate of the legal entity's expected losses based on reasonable quantitative evidence.*

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 entities' assets or liabilities. The presumption in the preceding paragraph does not relieve a reporting entity of its responsibility to determine whether a particular legal entity with which the reporting entity is involved

needs an equity investment at risk greater than 10 percent of its assets in order to finance its activities without subordinated financial support in addition to the equity investment.

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.

What are common situations in which a legal entity is determined to have insufficient equity?

The following are common examples of when an entity may be a VIE. However, the examples are not meant to be all inclusive and require a consideration of a specific situation's facts and circumstances:

- *The legal entity is thinly capitalized or does not have any equity investment at risk.* As noted above, ASC 810-10-25-45 indicates that “an equity investment at risk of **less** than 10 percent of the legal entity's total assets shall not be considered sufficient to permit the legal entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient” [emphasis added]. Absent evidence to the contrary, this entity is likely to be a VIE.

However, if the equity investment at risk is greater than 10 percent, that factor alone is not conclusive in determining whether equity is sufficient. Further analysis is needed.

Equity investment at risk greater than 10 percent

As discussed in ASC 810-10-25-45, demonstrating that an equity investment at risk is sufficient may be based on either a qualitative or quantitative analysis or a combination of both. Qualitative assessments based on comparisons to other entities that hold only similar assets of similar quality in similar amounts can be challenging and should consider operational characteristics, as well as economic characteristics, when assessing similarity.

- *The legal entity has debt that is guaranteed.* We believe the existence of a financial guarantee on the debt of an entity is a strong indicator that the equity investment at risk is not sufficient. However, not all guarantees are created equal, and the nature and reasons for the guarantee should be considered. For example, if the guarantee relates to representations and warranties, it likely would not mean that equity is not sufficient. Consider the following fact pattern: An entity is created to hold an apartment building, and the manager of the apartment building provides a guarantee to the lender connected to fraud and material misrepresentation related to leasing or operating the apartment building. Such a guarantee would not likely be considered subordinated financial support.

- *The entity has “other forms of subordinated financial support.”* For example, if the entity has preferred equity that is subject to a put by the holders, the entity would likely need additional subordinated financial support to satisfy the put.
- *The entity has future capital calls or commitments from investors.* Often such future capital calls or commitments indicate that the equity investment at risk is not sufficient. A commitment to fund equity is not considered equity investment at risk. In evaluating whether the equity investment at risk is sufficient, such analysis should consider whether the legal entity has equity investment at risk that is sufficient to carry on its activities without subordinated financial support. As such, it is important to determine whether the capital calls/commitments are an obligation to fund losses or to fund additional activities. The following two examples illustrate the differences:
 - Reporting Entities A and B are 50/50 investors in a legal entity that will operate an apartment building. Reporting Entities A and B each make an initial investment and commit to provide future capital as needed. Both entities have not guaranteed the debt. The reporting entities expect that future capital calls will be needed to finance the operations of the apartment building. In this fact pattern, the legal entity is a VIE.
 - Same as above fact pattern, except both parties do not expect that future capital calls will be needed to finance the operations of the apartment building. Rather, such capital commitments have been provided solely in the event the parties decide to acquire land next to the apartment building for future expansion. In this fact pattern, the legal entity is not a VIE because the capital commitment is not an obligation to fund losses but is for additional activities.

In both of the above fact patterns, the initial VIE conclusion needs to be re-evaluated upon the additional capital investment, consistent with the guidance in ASC 810-10-35-4.

Is a quantitative assessment needed to evaluate whether a legal entity has sufficient equity under ASC 810-10-15-14(a)?

A quantitative assessment is only needed if a qualitative assessment is not conclusive as to whether the legal entity has sufficient equity investment at risk and the legal entity is not otherwise deemed to be a VIE as explained in ASC 810-10-15-14(b) or (c). In other words, if a qualitative assessment is not conclusive in evaluating whether an entity is a VIE under ASC 810-10-15-14(a), we would recommend evaluating the other VIE conditions before attempting a quantitative assessment.

Can you provide some examples related to evaluating whether the equity at risk was provided to the equity investor by the legal entity (the condition in ASC 810-10-15-14(a)(3))?

Examples of such funding would be a fee, gift, charitable contribution, or other payment made to the investor by the entity or a party otherwise involved with the entity. For example, if investors pay a fee to the sponsor who is also an investor in the legal entity, the equity contribution of the sponsor would be reduced by the fees paid for purposes of determining equity investment at risk. Another example would be sweat equity, which is equity issued in return for services to the legal entity. Because the equity holder receives shares in lieu of a fee for services, the shares would be excluded from equity investment at risk.

Under ASC 810-10-15-14(a)(4), if the legal entity or any party involved with the legal entity provides an investor with a loan or a loan guarantee, how much of the equity investor’s investment would be considered “at risk”?

In determining the amount of the investment “at risk,” the equity investor would exclude the amount of the loan or the guaranteed amount from the amount considered at risk. For example, if the equity investor

made an equity investment of \$1,000 and received a loan from another variable interest holder of \$500, the equity investment at risk provided by such equity investor would be \$500.

ASC 810-10-25-45(b) provides an indicator that a legal entity has sufficient equity investment at risk if 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. How would one go about analyzing and supporting this?

Obtaining sufficient evidence to determine whether this condition applies to a specific situation can be difficult. For example, evidence that another entity has only assets that are sufficiently similar to those of the entity being analyzed may not be available. In addition, it may not be clear whether the entities used for comparison are themselves operating without subordinated financial support in addition to their equity investment at risk. Comparison to an entity that may be operating with subordinated financial support in addition to equity investment at risk would not support a conclusion that the entity being assessed has sufficient equity investment at risk.

Step 5.2 – Rights, benefits, and obligations of the holders of the equity investment at risk (ASC 810-10-15-14(b))

What does GAAP say

ASC 810-10-15-14(b) contains the following specific guidance about the holders of equity investment at risk:

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.*
 1. *If no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly impact the entity's economic performance, kick-out rights or participating rights (according to their VIE definitions) held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights shall not prevent the equity holders from having this characteristic unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A decision maker also shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 810-10-55-37 through 55-38.*

- ii. *For limited partnerships, partners lack that power if neither (1) nor (2) below exist. 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)*
 1. *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 the voting interest entity definition) through voting interests over the general partner(s).*
 - A. *For purposes of evaluating the threshold in (1) 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*
 2. *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)*
 3. *For purposes of (1) and (2) 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*
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.*
3. *The right to receive the expected residual returns of the legal entity. The investors do not have that right if their return is capped by the legal entity's governing documents or arrangements with other variable interest holders or the legal entity. For this purpose, the return to equity investors is not considered to be capped by the existence of outstanding stock options, convertible debt, or similar interests because if the options in those instruments are exercised, the holders will become additional equity investors.*

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

In evaluating ASC 810-10-15-14(b)(1), would the legal entity being evaluated for consolidation be a VIE if there are multiple classes of equity investment at risk, but only one of those classes has the power to direct the most significant activities?

No. The legal entity described in this question would not be a VIE, provided that at least one of the holders of the equity investment at risk has the power through voting or similar rights to direct the activities that most significantly impact the legal entity's economic performance. For example, if a corporation has both common stock and preferred stock that represents equity investment at risk but only the common stock has voting rights, it would not be a VIE under ASC 810-10-15-14(b)(1).

In evaluating ASC 810-10-15-14(b)(1), should rights held by an equity holder in other contractual agreements (for example, a separate management agreement) with the legal entity be considered in determining whether the holders of the equity investment at risk have power?

It depends. As noted above, ASC 810-10-15-14 states that “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 other words, if the most significant activities are directed through other agreements/arrangements with the VIE (for example, a management agreement), the entity likely is a VIE when such rights are not embedded in the equity interests.

However, it may be possible that the management agreement is embedded in the equity interest. Such agreements require an in-depth evaluation based on the specific facts and circumstances. Consider the following example scenarios (all assume that the manager has power through the management agreement):

- If the reporting entity can sell its equity interest and continue to be the manager under the management services agreement, this would likely indicate that the management agreement is not embedded in the equity interest, and the entity would therefore be a VIE under ASC 810-10-15-14(b)(1).
- If a reporting entity can discontinue its duties as manager, but retain its equity interest, this would likely indicate that the management agreement is not embedded in the equity interest, and therefore the entity would be a VIE under ASC 810-10-15-14(b)(1).
- If the reporting entity cannot sell its equity interest without being required to discontinue its duties as manager, this would likely indicate that the management agreement is embedded in the equity interest, and therefore the entity would not be a VIE based on ASC 810-10-15-14(b)(1).

Under ASC 810-10-15-14(b)(1), when would kick-out rights and participating rights be considered in the consolidation analysis?

Kick-out and participating rights are considered in assessing whether the equity holders at risk lack the power to control the activities that most significantly impact the economic performance of the legal entity under ASC 810-10-15-14(b)(1) only if (1) a single party, including its related parties and de facto agents, has the unilateral ability to exercise such rights, and (2) such rights are determined to be substantive (see the guidance in Step 1 relating to evaluating whether kick-out or participating rights are substantive). The legal entity’s board of directors should not be treated as a single party for the purpose of assessing kick-out or participating rights. For example, if an entity’s decision maker can be removed unilaterally by a majority vote of the board of directors, such removal right would not be considered in the consolidation analysis if a majority vote requires multiple parties to agree. However, if a single party has a majority of the votes necessary to exercise such right, such right would be considered in the analysis.

Can you provide some examples of when equity investors would be considered protected from absorbing an entity’s expected losses under ASC 810-10-15-14(b)(2)?

The following examples illustrate how certain interests could affect the determination of whether equity investors are protected from absorbing an entity’s expected losses:

- *Purchased put on the legal entity’s assets:* Assume that a legal entity’s total assets are \$100, debt is \$90, and expected losses and equity are \$10. If the legal entity purchases a put that permits it to put its assets to the put writer for \$100, the legal entity would be a VIE, because the put protects the holders of the equity investment at risk from absorbing expected losses. However, if the put exercise

price were \$90, the equity investors would absorb a decline in the value of the assets equal to the expected losses and their equity investment. The put would, in effect, guarantee the \$90 of debt, which would not cause the legal entity to be a VIE.

- *Guarantees of debt:* A guarantee of the legal entity's debt provided by a party involved with the legal entity would not cause the legal entity to be a VIE if the guarantee does not protect the holders of the equity investment at risk from incurring the first dollar risk of loss in an amount at least equal to the legal entity's expected losses. However, if that guarantee protects those equity investors from absorbing the expected losses, it would cause the legal entity to be a VIE.
- *Residual value guarantee:* Similar to a guarantee of debt, a residual value guarantee on an asset that represents more than 50 percent of the total fair value of the legal entity's assets would cause an entity to be a VIE if it protects the holders of the equity investment at risk from the first dollar risk of loss on the expected residual value of the asset. Assume that the expected residual value is \$250 and the equity investment at risk and expected losses are each \$50. A residual value guarantee of \$225 would protect those equity investors from losses greater than \$25 and would cause the legal entity to be a VIE because expected losses are \$50. However, a residual value guarantee of \$150 would result in those equity investors losing all of their investment, but it would protect the legal entity's lenders to the extent of a decline in the residual value below \$150. That residual value guarantee therefore would not cause the legal entity to be a VIE.
- *Guaranteed return:* If the legal entity or a party involved with the legal entity guarantees holders of the equity investment at risk a return of their investment or a return on their investment, the legal entity would be a VIE.

How does a cap on equity interests impact the assessment of whether the equity holders have the right to receive the legal entity's expected residual returns?

Equity interests, such as preferred stock, may be capped and still have the right to receive the legal entity's expected returns, provided both of the following conditions apply:

- Other holders of equity investments at risk have a right to the residual returns in excess of the cap. In that case, the equity investors, as a group, have the right to receive the expected residual returns.
- The preferred shareholders' return permits them to participate significantly in the legal entity's profits and losses.

In some joint venture or partnership arrangements, profit allocations may be proportional to ownership percentages for a period of time or until certain investors receive a specified internal rate of return, after which the allocation changes. Although such arrangements may cap certain investors' returns, the legal entity would not meet this condition (and therefore would not be a VIE because of this provision), provided that the equity owners, as a group, receive the legal entity's expected residual returns. However, when a legal entity's profit allocation has such provisions, the reporting entity should consider the guidance in ASC 810-10-15-14(c) concerning disproportionate voting interests relative to the obligation to absorb expected losses and the right to receive residual returns.

Step 5.3 – How kick-out rights impact the analysis of limited partnerships and similar legal entities (ASC 810-10-15-8A)

The guidance in ASC 810-10-15-8A states that

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 may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree.

This guidance, when read in combination with the guidance in ASC 810-10-25-2 through 25-14C, means that if a limited partnership provides limited partners with either substantive kick-out rights or substantive participating rights, then the limited partnership should be evaluated as a voting interest entity. Accordingly, if the limited partnership is a voting interest entity, the party with a controlling financial interest (that is, the party with the majority of substantive kick-out rights or participating rights) would consolidate the limited partnership.

Step 5.4 – Anti-abuse clause

What does GAAP say

The guidance in ASC 810-10-15-14(c) describes when a reporting entity should apply the anti-abuse clause as follows:

The equity investors as a group also are considered to lack the characteristic in (b)(1) if both of the following conditions are present:

- 1. The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their rights to receive the expected residual returns of the legal entity, or both.*
- 2. Substantially all of the legal entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a VIE by organizing the legal entity with nonsubstantive voting interests. Activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights shall be treated as if they involve or are conducted on behalf of that investor. The term related parties in this paragraph refers to all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d).*

For purposes of applying this requirement, reporting entities shall consider each party's obligations to absorb expected losses and rights to receive expected residual returns related to all of that party's interests in the legal entity and not only to its equity investment at risk.

In evaluating whether substantially all of the legal entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights, should the analysis be based on the investments made by the investor and its related party group?

No. While the investor's economic interests in the legal entity should be considered, and might be so significant that they represent either the obligation to absorb substantially all of an entity's expected losses or the right to receive substantially all of an entity's expected residual returns, this should not be the only factor to consider. The analysis should consider the purpose and design of the entity, including the risks the entity was designed to pass along, and the reason that the investor has disproportionately few voting rights. Activities that involve, or are conducted on behalf of, the investor should be considered broadly from a qualitative perspective, as well as the relative importance of those activities to the investor and to the legal entity. Activities at the time of the investor's initial involvement with the legal entity should also be considered along with activities that are expected to be ongoing. For instance, sales between the reporting enterprise and the legal entity, as well as services performed by the legal entity for the reporting enterprise and services performed by the reporting enterprise for the entity, should be considered.

In evaluating whether a legal entity is a VIE pursuant to the anti-abuse clause in ASC 810-10-15-14(c), how are related parties considered?

For the purpose of applying ASC 810-10-15-14(c)(2), the SEC staff has indicated that a close business associate of an investor may be considered the investor's related party under either ASC 850 or ASC 810-10-25-43 only if one party can control or significantly influence the other party to the extent that one party might be prevented from pursuing its own interests. The SEC staff has stated, "[T]he mere past practice or future intent of close business associates to collaborate would be insufficient to conclude the parties are related."

Step 6 – If the legal entity being evaluated for consolidation is a VIE, determine who would consolidate the entity

A reporting entity should consolidate a legal entity over which it has a "controlling financial interest." The guidance stipulates that a controlling financial interest has two components: an "economics" component (the right to receive benefits or the obligation to absorb losses that could potentially be significant), and a "power" component (the power to direct the activities that most significantly impact economic performance). For voting interest entities, a majority of voting rights (or, for limited partnerships, substantive kick-out rights) provides a controlling financial interest. But for VIEs, the analysis as to whether the reporting entity has a controlling financial interest is more complex.

The reporting entity that holds a controlling financial interest in, and therefore consolidates, a VIE is called the "primary beneficiary." Generally, if a reporting entity has a variable interest in the legal entity/VIE, it will meet the second condition of a primary beneficiary in ASC 810-10-25-38A(b) (see below under "What GAAP says"). In practice, multiple variable interest holders typically meet the second condition.

As a result, the key factor in determining the primary beneficiary involves determining what are the activity(ies) of the VIE that most significantly impact the VIE's economic performance and who directs such activities (ASC 810-10-25-38A(a)).

What GAAP says

The guidance in ASC 810-10-25-38A describes the two criteria used to determine whether a reporting entity has a controlling financial interest in a VIE, and is therefore that VIE's primary beneficiary, as follows:

A reporting entity with a variable interest in a VIE shall assess whether the reporting entity has a controlling financial interest in the VIE and, thus, is the VIE's primary beneficiary. This shall include an assessment of the characteristics of the reporting entity's variable interest(s) and other involvements (including involvement of related parties and de facto agents), if any, in the VIE, as well as the involvement of other variable interest holders. Paragraph 810-10-25-43 provides guidance on related parties and de facto agents. Additionally, the assessment shall consider the VIE's purpose and design, including the risks that the VIE was designed to create and pass through to its variable interest holders. A reporting entity shall be deemed to have a controlling financial interest in a VIE if it has both of the following characteristics:

- a. The power to direct the activities of a VIE that most significantly impact the VIE's economic performance*
- b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The quantitative approach described in the definitions of the terms expected losses, expected residual*

returns, and expected variability is not required and shall not be the sole determinant as to whether a reporting entity has these obligations or rights.

Only one reporting entity, if any, is expected to be identified as the primary beneficiary of a VIE. Although more than one reporting entity could have the characteristic in (b) of this paragraph, only one reporting entity, if any, will have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance.

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.

ASC 810-10-25-38C –

A reporting entity's determination of whether it has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance shall not be affected by the existence of kick-out rights or participating rights unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those kick-out rights or participating rights. A single reporting entity (including its related parties and de facto agents) that has the unilateral ability to exercise kick-out rights or participating rights may be the party with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. These requirements related to kick-out rights and participating rights are limited to this particular analysis and are not applicable to transactions accounted for under other authoritative guidance. Protective rights held by other parties do not preclude a reporting entity from having the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

ASC 810-10-25-38D –

If a reporting entity determines that power is, in fact, shared among multiple unrelated parties such that no one party has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and if decisions about those activities require the consent of each of the parties sharing power. If a reporting entity concludes that power is not shared but the activities that most significantly impact the VIE's economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities shall be considered to have the characteristic in paragraph 810-10-25-38A(a).

ASC 810-10-25-38E –

If the activities that impact the VIE's economic performance are directed by multiple unrelated parties, and the nature of the activities that each party is directing is not the same, then a reporting entity shall identify which party has the power to direct the activities that most significantly impact the VIE's economic performance. One party will have this power, and that party shall be deemed to have the characteristic in paragraph 810-10-25-38A(a).

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.

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.

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*

ASC 810-10-25-38I –

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

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

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

ASC 810-10-25-38J –

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

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

Therefore, those fees shall be considered for evaluating the characteristics 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.

As of what date should a reporting entity assess whether it is the primary beneficiary of a VIE?

If a reporting entity holds a variable interest in a legal entity that is a VIE, then the reporting entity must assess whether it is the primary beneficiary of the VIE as of the date of its initial involvement with the VIE and continuously thereafter. Thus, consolidation/deconsolidation could be required as of any date within a reporting period, depending on the facts and circumstances.

A change in facts and circumstances could affect the determination of whether a reporting entity is the primary beneficiary of a VIE without triggering reconsideration of whether the legal entity is a VIE. For example, the transfer of a VIE's outstanding debt from the existing creditor to an unrelated party, without any modification of the debt agreement's terms and conditions, would neither change the design of the entity nor trigger reconsideration of whether the entity is a VIE. However, the new debt holder would need to consider whether it is the primary beneficiary of the entity as of the date of transfer.

Step 6.1 – Determine the most significant activity(ies) of the VIE

The activities that most significantly impact the economic performance of an entity must be identified in order to determine which party, if any, has the power to direct those activities. The nature of the most significant activities varies, depending on the type of entity. For some entities with a more limited range of activities than operating companies, the activities that most significantly impact their economic performance might need to occur only when certain circumstances arise or certain events occur (see the box below for examples).

Determining the most significant activity(ies) of a VIE involves consideration of the purpose and design of the entity, focusing on activities that impact

- The fair value of the entity or the entity's assets
- Cash flows of the entity
- Profitability of the entity
- Returns to the variable interest holders

Determining "significant" activities

Securitization entity

The FASB has indicated that the only activity likely to significantly impact the economic performance of certain securitization entities includes the management of troubled assets. As a

result, the party with the power to direct those activities, even if that power is not exercised, has the “power” characteristic of a controlling financial interest in the entity.

For example, in Case A, “Commercial Mortgage-Backed Securitization,” in ASC 810-10-55-96 through 55-109, the management of assets that are delinquent or in default in a mortgage-backed securitization entity is identified as an activity that significantly impacts the entity’s economic performance. Also, refer to Paragraph A38 in the Basis of Conclusions of Statement of Financial Accounting Standards 167, *Amendments to FASB Interpretation No. 46(R)*.

Operating entity

A commercial manufacturing entity’s most significant activities are likely to relate to the operations of the entity, such as manufacturing, sales, and distribution. Consequently, a senior lender’s right to take possession of the manufacturing entity’s assets in the event of a materially adverse change in circumstances might be considered a protective right. As illustrated in Case I, “Furniture Manufacturing Entity,” in ASC 810-10-55-199 through 55-205, the lender’s protective rights do not provide it with the power to direct the operating activities that most significantly impact the economic performance of the manufacturing entity.

Real estate entity

A VIE entity owns a recently updated apartment building. The most significant activities likely are (1) maintenance of the building (as that would impact the fair value of the building and whether one would want to live in the apartment building), and (2) activities related to renting the units, including, but not limited to, determining rental prices, negotiating with prospective and current tenants, marketing, and other related activities. Other decisions of the entity that may be deemed “major decisions,” such as securing new borrowings, approving new investors, selling the building, and issuing debt or equity securities, likely do not relate to the significant decisions of the entity and would be considered protective rights.

Certain contractual arrangements (for example, LLC or partnership agreements) may identify “major decisions.” But, in general, are “major decisions” the same as the “most significant activities”?

Generally, no. However, entities should closely evaluate the nature of the major decisions to determine whether such rights provide the reporting entity with power, a participating right, or a protective right. Such determination will depend on the entity being evaluated and on how the major decisions relate to the most significant activities of the VIE.

Can significant activities change over time?

The nature of a legal entity’s activities and the party with power over those activities may change over time. The assessment of which party, if any, has the “power” characteristic of a controlling financial interest in the legal entity should involve consideration of an entity’s activities and which party has power over the expected life of the legal entity. The expected duration of a particular activity and the degree of uncertainty of the activity’s outcome are factors that could affect the primary beneficiary determination.

Examples of significant activities expected to change over time

Research and development entity

A legal entity is designed to research, develop, and produce a new drug. In this entity, one party will make the significant decisions until a new drug candidate receives FDA approval, then another party will make all decisions on manufacturing, marketing, and distributing that drug. The production and sales period may be expected to be longer than the research phase of the entity, which could be an indicator that the manufacturing, marketing, and distribution activities have a more significant impact on economic performance over the life of the entity. However, significant uncertainty about the ultimate outcome of the research might indicate that the research activities are more significant to the entity's economic results until that uncertainty is reduced or eliminated. At that time, the primary beneficiary determination would need to be reconsidered as the manufacturing and marketing activities become the most significant.

Construction phase of operating entity

In contrast to the research and development example, consider an entity designed to construct and operate a facility. For this entity, one party will have the ability to make the significant decisions only during the construction of the entity's operating facility; thereafter, another party will manage all operating activities of the entity. Over the expected life of the entity, the operating period is expected to be significantly longer than the initial construction period. In addition, there may be little uncertainty about the entity's ability to complete the construction and begin operations. In this example, the operating activities of the entity may have the most significant impact on economic performance over the life of the entity, even during the construction period.

Is it possible for an entity to have no significant activities?

No. In fact, the SEC staff weighed in on this question at the 2009 AICPA National Conference on Current SEC and PCAOB Developments. At that conference, an SEC staff member addressed a question on whether the staff had encountered a situation in which an entity has no ongoing activities that require decision making. The question was raised in the context of applying the "power" characteristic when determining the primary beneficiary of a VIE. In response, the staff member indicated that based on past experience with qualifying special-purpose entities, the staff is skeptical about the existence of any truly "brain dead" entities with no significant activities that require ongoing decision making.

It is important to also consider Paragraph A38 in the Basis of Conclusions for FAS 167, which notes the following guidance on this topic:

For example, for an entity with a limited range of activities, such as certain securitization entities or other special-purpose entities, power is determined on the basis of who directs that limited range of activities. The Board reasoned that, in certain securitization entities, it is likely that the only activities that will significantly impact the economic performance of the entity include the management of troubled assets. In an operating entity, there would often be a wider range of activities that would need to be analyzed to determine which activities most significantly impact the economic performance of the entity. In addition, the Board reasoned that if the activities that most significantly impact the economic performance of a variable interest entity would only need

to occur when certain circumstances arise or certain events happen, then the party that has the power to direct those activities still has power over the entity.

Step 6.2 – Determine who directs the most significant activity(ies) of a VIE

In evaluating who has the power to direct the most significant activity(ies) of a VIE, a reporting entity should consider all sources of power, all agreements and arrangements, and the governance of the entity. At the 2010 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member noted that

[I]t may be important to look beneath the activities of the Board of Directors—such as to activities within management, servicing, or financing arrangements—to identify the party with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

As a result, it is common that the power to direct the most significant activities does not reside within an entity's equity interests.

What happens if the most significant activities of a VIE are directed by multiple unrelated parties?

The activities that most significantly impact a VIE's economic performance may be directed by multiple unrelated parties. If the activities that most significantly impact a VIE's economic performance are directed by the reporting entity and one or more other unrelated parties, the analysis to identify the VIE's primary beneficiary should apply the following guidance:

- *If power is shared, there is no primary beneficiary.* Power is shared if two or more unrelated parties together have the power to direct the most significant activities of a VIE and if decisions about each of those activities require the consent of each of the parties sharing power.

Shared power

Consider an operating entity for which manufacturing, distributing, and selling a beverage are identified as the activities that most significantly impact the operating entity's economic performance. The operating entity is owned by two unrelated parties, Company A and Company B, which have equal voting rights in the entity. Company A and Company B are each responsible for manufacturing activities, and Company B is also responsible for all distribution and sales activities. However, all decisions about the manufacturing, distribution, and sales activities require the consent of both companies. In this example, the power to direct the activities that most significantly impact the entity's economic performance is shared.

- *If the power over some, but not all, of the activities that most significantly impact the operating entity's economic performance is shared, the power over the activities that is not shared should be considered.* Power is only shared if two or more unrelated parties together have the power to direct all of the most significant activities of a VIE and if decisions about all of those activities require the consent of each of the parties sharing power.

Power over some, but not all, of significant activities is shared

Consider an operating entity for which manufacturing, distributing, and selling a beverage are identified as the activities that most significantly impact the operating entity's economic performance. The operating entity is owned by two unrelated parties, Company A and Company B, which have equal voting rights in the entity. All decisions about manufacturing and distribution activities require the consent of both companies. However, Company A unilaterally directs the sales activities. Company B may conclude that the power over the sales activities represents power over more of the activities that most significantly affect the entity's economic performance, and Company A would have the power characteristic of a controlling financial interest.

- *If power is not shared, the nature of the activities each party is directing should be considered.*
 - If the nature of the activities that each party is directing is not the same, then the party with the power to direct the activities that most significantly impact the VIE's economic performance has the "power" characteristic of a controlling financial interest.

Power over different types of significant activities is held by multiple unrelated parties

Consider an example similar to the previous example, but assume Company A is solely responsible for manufacturing while Company B is solely responsible for distribution and sales. If the decisions about manufacturing, distribution, and sales activities do not require the consent of both companies, then power is not shared. The nature of the activities directed by the two companies is not the same because Company B is responsible for distribution and sales activities, while Company A is responsible for the manufacturing activities. Although it does not have power over the manufacturing activities, Company B may conclude that the power over the distribution and sales activities represents power over the activities that most significantly affect the entity's economic performance.

- If the nature of the activities that each party is directing is the same, then the party with the power to direct a majority of the activities that most significantly impact the VIE's economic performance, if such party exists, has the power characteristic of a controlling financial interest. However, if no party has the power to direct a majority of those activities, the VIE has no primary beneficiary.

Power over same type of significant activities is held by multiple unrelated parties

Continuing the basic fact pattern in the previous examples, now assume that all decisions regarding distribution and sales require mutual consent. However, also assume that the manufacturing activities are not jointly controlled, but that Company A manufactures beverages to be distributed in certain geographies, while Company B manufactures beverages to be

distributed in all other geographies. In this example, the nature of the manufacturing activities for which Company A and Company B are individually responsible is the same. Because Company A and Company B are each responsible for some of the manufacturing activities, the company with the power over a majority of the manufacturing activities would have the power characteristic of a controlling financial interest.

Can power be shared among related parties?

No. If neither the reporting entity nor one of its related parties has both characteristics of a controlling financial interest in a VIE under ASC 810-10-25-38A, but the reporting entity and its related parties and de facto agents, as a group, have both characteristics and power is shared among members of the related party group, then the party within the related-party group that is most closely associated with the VIE is the primary beneficiary.

Shared power among related parties

At the 2010 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff observed that parties within a related-party group cannot conclude that power is shared within the related-party group and that there is no primary beneficiary within the related-party group because power is shared. One party within the related-party group must be identified as the primary beneficiary.

Step 6.3 – Determine which party(ies) have an obligation to absorb losses or the right to receive benefits from the VIE that could potentially be significant to the VIE

If the reporting entity has the power to direct the activities that most significantly impact the VIE's economic performance, then the reporting entity must assess whether it also has the obligation to absorb losses, or the right to receive benefits, of the VIE that could potentially be significant to the VIE.

It is possible that more than one entity involved with a VIE could have an obligation to absorb losses, or a right to receive benefits, that could potentially be significant to the VIE. A reporting entity may have an obligation to absorb losses, or a right to receive benefits, that could potentially be significant to the VIE even if it is not probable that the losses will occur or the benefits will be received. The reporting entity should consider whether it meets the economic interest condition under any possible loss or benefit outcome scenario without considering the probability that a particular outcome will occur.

It is important to note that the consideration of losses or benefits that could potentially be significant should not be based on "expected losses" or "expected residual returns," as defined in ASC 810-10-20. In addition, while the right to receive income of a VIE that could potentially be significant to the VIE would likely mean that a party meets the economic condition, a party can receive benefits from a VIE without having the right to receive net income of a VIE. We believe that the FASB did not intend the term "benefits" to be limited to net income or expected residual returns in this situation.

Potential significance of fees

Case D in ASC 810-10-55-134 through 55-146 describes a commercial paper conduit entity. In that example, the sponsor's fixed fee, calculated as a fixed percentage of asset value, is determined to provide benefits that could potentially be significant to the entity. However, the FASB has indicated that a service provider's fixed-fee arrangement would not, by itself, represent an obligation or benefit that could potentially be significant to a VIE. For example, a loan servicer that is paid a fee that is a fixed percentage of the balance of a VIE's loans may be able to conclude, based on a consideration of the magnitude of the fixed percentage, that the fee could not be potentially significant to the entity.

It is important to note that the magnitude of the fee alone would not cause the fee to be a variable interest. Rather, the sponsor's management fee should be evaluated to determine if it is (a) compensation for services provided and commensurate with the level of effort required to provide the services, and (b) part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

The example demonstrates that the sponsor's management fee would not be a variable interest if the sponsor was not also providing a letter of credit and liquidity facility. The letter of credit and liquidity facility expose the sponsor to risk of loss and are therefore a variable interest. Accordingly, the sponsor has a variable interest other than the management fee that exposes the sponsor to more than an insignificant amount of the VIE's variability, and, pursuant to ASC 810-10-55-37(c), the management fee is also considered part of the sponsor's variable interest.

At the 2009 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member stated that there is no "bright line set of criteria" for assessing the potential significance of a financial interest. The staff member observed that the determination of what could potentially be significant is a matter of judgment, based on consideration of both qualitative and quantitative factors. The staff member suggested that qualitative factors to consider in determining whether a reporting entity has a controlling financial interest should include, but are not limited to, the following factors:

- The purpose and design of the entity, including identification of the risks the entity was designed to create and pass on to its variable interest holders
- The terms and characteristics of the financial interests in the entity, including an interest's seniority level. However, the probability of an event occurring would generally not be a factor in the assessment of whether a financial interest could be potentially significant.
- The reporting entity's business purpose for holding the financial interest

Primary beneficiary determination

One of the characteristics that identifies the primary beneficiary of a VIE is the obligation to absorb losses, or the right to receive benefits, that could potentially be significant to the VIE. Losses and benefits considered in the primary beneficiary assessment do not refer to "expected losses" and "expected residual returns," as defined in ASC 810-10. A reporting entity may

consider its exposure or rights to a VIE's expected losses or expected residual returns to identify the primary beneficiary. However, the reporting entity is prohibited from using only expected losses and expected residual returns to determine whether it has an obligation to absorb losses, or the right to receive benefits, that are potentially significant to a VIE.

Step 6.4 – The effect of related parties

The relationship of the reporting entity's related parties to a VIE can greatly influence whether the reporting entity is the primary beneficiary of the VIE. Importantly, related parties are evaluated differently depending on whether there is a single decision maker with regard to a VIE or whether decision-making power is shared among multiple variable interest holders. A variable interest holder is a single decision maker when it has the power to direct the activities that most significantly impact the economic performance of a VIE.

See Appendix C for a flowchart that visualizes this analysis.

A single decision maker

When the reporting entity is the single decision maker (that is, the entity by itself satisfies the "power" criteria in 810-10-25-38A(a)), the reporting entity must then evaluate whether it meets the "economic" criteria in 810-10-25-38A(b) as well, considering both its direct variable interests in the VIE and the interests of related parties on an indirect and proportionate basis. The analysis as to whether the single decision-maker reporting entity meets the economic criteria is not impacted by whether the related party with a variable interest in the VIE is under common control with the reporting entity. If the reporting entity has a direct ownership interest in the related party, then the reporting entity must consider the related party's variable interest in the VIE on an indirect and proportionate basis, as illustrated below in ASC 810-10-25-42. If the reporting entity does not have a direct ownership interest in the related party (for instance, if the reporting entity and the related party are brother-sister entities, both wholly owned subsidiaries of the same parent entity), then the reporting entity would not consider the variable interest held by the related party in the VIE when evaluating whether the reporting entity meets the economic condition.

If, after analyzing both its direct and proportionate indirect variable interests in the VIE, the single decision-maker reporting entity concludes that it does not meet the economic criteria in ASC 810-10-25-38A(b), the reporting entity must then consider whether it and its related parties collectively meet the economic criteria. If the single decision maker and its related parties do not collectively meet the economic criteria, neither the single decision maker, nor any of its related parties, should consolidate the VIE.

If the single decision maker and its related parties that are under common control meet the economic criteria in ASC 810-10-25-38A(b) as a group, then the reporting entity should apply the related party tie-breaker guidance in ASC 810-10-25-44, and the member of the related-party group under common control that is most closely associated with the VIE would be the primary beneficiary.

If the single decision maker and its related parties under common control, as a group, do not meet the economic criteria in ASC 810-10-25-38A(b), then the single decision maker should evaluate whether it and its related parties (whether or not under common control) meet the economic criteria. If that broader related-party group does meet the economic criteria, and if substantially all of the activities of the VIE involve or are conducted on behalf of a single entity within that group, that entity should consolidate the VIE.

ASC 810-10-25-42 includes the following guidance about determining when a single decision maker comprises the primary beneficiary of a VIE:

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

ASC 810-10-25-44A –

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

ASC 810-10-25-44B –

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

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

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

No single decision maker

There are situations where there is no single decision maker, such as when the power to direct the activities that most significantly impact economic performance is shared, or when a VIE has multiple

activities that most significantly impact economic performance and those activities are not all controlled by a single entity. If there is no single decision maker and the reporting entity does not meet both the power and economic criteria in ASC 810-10-25-38A, then the reporting entity should evaluate whether it and its related parties (regardless of whether they are under common control), as a group, meet both the power and economic criteria. If the power and economic criteria are met as a related-party group, then the entity within the related-party group most closely associated with the VIE is the primary beneficiary of the VIE.

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*

Identifying de facto principles and agents

For purposes of applying the VIE subsections in ASC 810, de facto agents and de facto principles of the reporting entity should be considered its related parties unless otherwise specified, as indicated in ASC 810-10-25-43:

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

- a. *A party that cannot finance its operations without subordinated financial support from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary*
- b. *A party that received its interests as a contribution or a loan from the reporting entity*
- c. *An officer, employee, or member of the governing board of the reporting entity*
- d. *A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.*

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

Step 7 – Evaluate presentation and disclosure requirements

Presentation

The primary beneficiary of a VIE must separately show both of the following items on its balance sheet:

- A consolidated VIE's assets that can be used only to settle the VIE's obligations
- A consolidated VIE's liabilities for which the creditors or beneficial interest holders lack recourse to the general credit of the primary beneficiary

Disclosures

The following reporting entities must obtain necessary information and provide the disclosures required by ASC 810-10-50, *Variable Interest Entities* subsection:

- A reporting entity that is the primary beneficiary of a VIE
- A reporting entity that has a variable interest in a VIE but is not the primary beneficiary
- A reporting entity that has not applied the guidance in ASC 810-10, *Variable Interest Entities* subsections, to a legal entity created before December 31, 2003 due to the lack-of-information condition described in ASC 810-10-15-17(c)

Appendix D provides a detailed list of disclosure requirements.

Other matters

Initial consolidation

For the initial consolidation of a VIE, the primary beneficiary must measure and recognize the VIE's assets, liabilities, and noncontrolling interests in accordance with the guidance in ASC 810-10-30-1 through 30-4, as follows:

- If the primary beneficiary and the VIE were under common control prior to the primary beneficiary obtaining control of the VIE, then the VIE's assets, liabilities, and noncontrolling interests are initially measured upon consolidation at the amounts they are carried in the U.S. GAAP accounts of the ultimate parent of both entities, pursuant to ASC 810-50.
- If the VIE is a business that is not under common control with its primary beneficiary, then the primary beneficiary accounts for the initial consolidation of the VIE as a business combination under ASC 805, *Business Combinations*.
- If the VIE is not a business and is not under common control with its primary beneficiary, then
 - The primary beneficiary initially measures and recognizes the VIE's identifiable assets and liabilities in accordance with ASC 805. However, assets and liabilities that the primary beneficiary transferred to the VIE at, or shortly before, the initial consolidation are measured as if they had not been transferred.
 - The primary beneficiary recognizes a gain or loss on initial consolidation that is measured as the difference between (1) the sum of the fair value of consideration transferred, the fair value of any

noncontrolling interests, and the carrying amount of any interests in the VIE previously held by the primary beneficiary, and (2) the net identifiable assets and liabilities of the VIE, as measured and recognized in accordance with ASC 805. No goodwill is recognized.

Upon initial consolidation of a collateralized financing entity, the primary beneficiary should consider the initial measurement guidance in ASC 810-10-30-10 through 30-15 and the subsequent measurement guidance in ASC 810-10-35-6 through 35-9. A VIE is a collateralized financing entity if it meets both of the following conditions described in ASC 810-10-15-7D:

- All of the financial assets and the financial liabilities of the collateralized financing entity are measured at fair value in the consolidated financial statements under other applicable Codification Topics, other than financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).
- The changes in the fair values of those financial assets and financial liabilities are reflected in earnings.

Consolidation upon loss of scope exception for lack of information

If a reporting entity has not applied the ASC 810-10, *Variable Interest Entities* subsections, guidance to a legal entity based on the lack-of-information condition described in ASC 810-10-15-17(c), but subsequently obtains the necessary information, it must measure the assets, liabilities, and noncontrolling interests of the VIE as of the date the information is acquired, in accordance with the guidance in ASC 810-10-30-8.

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For additional information on topics covered in this bulletin, contact your Grant Thornton LLP professional.

Appendix A

Consultation tool

The following steps are consistent with the guidance in the bulletin and can be used to document the VIE analysis.

Step 1 – Obtain and document an understanding of the purpose and design of the entity being evaluated for consolidation

Step 2 – Determine whether the entity being evaluated for consolidation is a legal entity

Step 3 – Determine the variable interests in the legal entity being evaluated for consolidation

Step 4 – Determine whether the reporting entity qualifies for any scope exceptions or is a private company that qualifies for the accounting alternate to the VIE guidance for common-control leasing arrangements

Step 5 – Determine whether the legal entity being evaluated for consolidation is a VIE

Step 6 – If the legal entity being evaluated for consolidation is a VIE, determine who would consolidate the entity

Step 7 – Evaluate presentation and disclosure requirements

Appendix B

Definitions

This appendix provides definitions of certain terms used in ASC 810-10, *Variable Interest Entities* subsections.

Terms	Definitions
Participating rights	The ability to block the actions through which an entity exercises its power to direct the most significant activities of a VIE (or a potential VIE)
Primary beneficiary	The reporting entity that consolidates a VIE
Subordinated financial support	Variable interests that will absorb some or all of a legal entity's expected losses
Variable interest	Interests that will absorb portions of a VIE's expected losses or receive portions of the VIE's expected residual returns. 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.
Variable interest entity (VIE)	A legal entity subject to consolidation according to the provisions of ASC 810-10, <i>Variable Interest Entities</i> subsections
Expected variability	A VIE's expected variability is the sum of the absolute values of the expected residual return and the expected loss. Expected variability in the fair value of net assets includes expected variability resulting from the operating results of the VIE.
Kick-out rights	The ability to remove the entity with the power to direct the activities that most significantly affect a VIE's (or a potential VIE's) economic performance
Legal entity	Any legal structure used to conduct activities or to hold assets

Appendix C

Related-party considerations

A reporting entity should consider the interests held by its related parties in a VIE in two instances:

1. When determining whether a fee paid to a decision maker or service provider is a variable interest, as discussed in Step 3
2. When no single party has both characteristics of a primary beneficiary, as described in Step 6.4

Impact of related parties in determining whether a decision maker or service provider fee is a variable interest

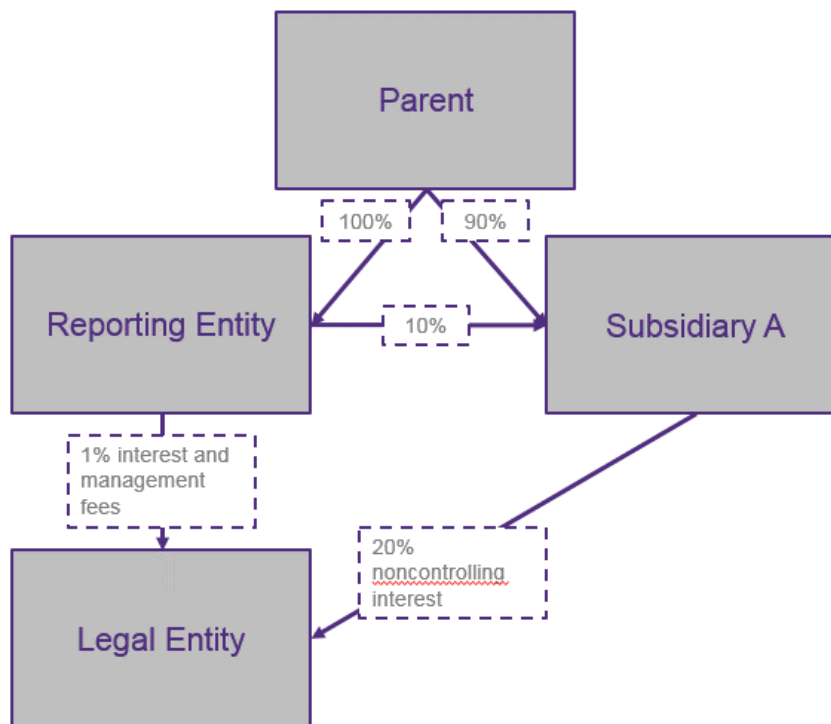
When determining whether a fee paid to a decision maker or service provider is a variable interest, the consideration of interests held by related parties (introduced in Paragraph 810-10-55-37D) should be on a proportionate basis, unless a related party is under common control. If the reporting entity has an ownership interest in a related party with a variable interest in the legal entity, and the reporting entity and the related party are not under common control, then the reporting entity should consider that related party's interest on a proportionate basis. Alternatively, if the related party with a variable interest in the legal entity is a brother-sister entity with the reporting entity (that is, they are under common control) and the reporting entity has an ownership interest in the related party, then the reporting entity should consider the related party's entire interest. However, if the related party with a variable interest in the legal entity is a brother-sister entity with the reporting entity (that is, they are under common control), but the reporting entity does not have an ownership interest in the related party, then the reporting entity would not consider the related party's interest when evaluating whether the fee received from the legal entity is a variable interest.

When determining whether the reporting entity is the primary beneficiary of the VIE, as described in Step 6.4, any indirect interests should only be considered on an indirect and proportionate basis, without regard to whether the related parties through which the reporting entity holds indirect interests are under common control with the reporting entity. This may result in a determination that a fee paid to the reporting entity as a decision maker or service provider is a variable interest, and yet that variable interest may not expose the reporting entity to more than insignificant variability.

Consider the following example:

A reporting entity has a 1 percent direct investment in a legal entity that is a VIE. The reporting entity also receives management fees from the VIE. Additionally, Subsidiary A, which is under common control with the reporting entity, has a 20 percent interest in the VIE, and the reporting entity has a 10 percent interest in Subsidiary A. This scenario is illustrated in the diagram on the next page.

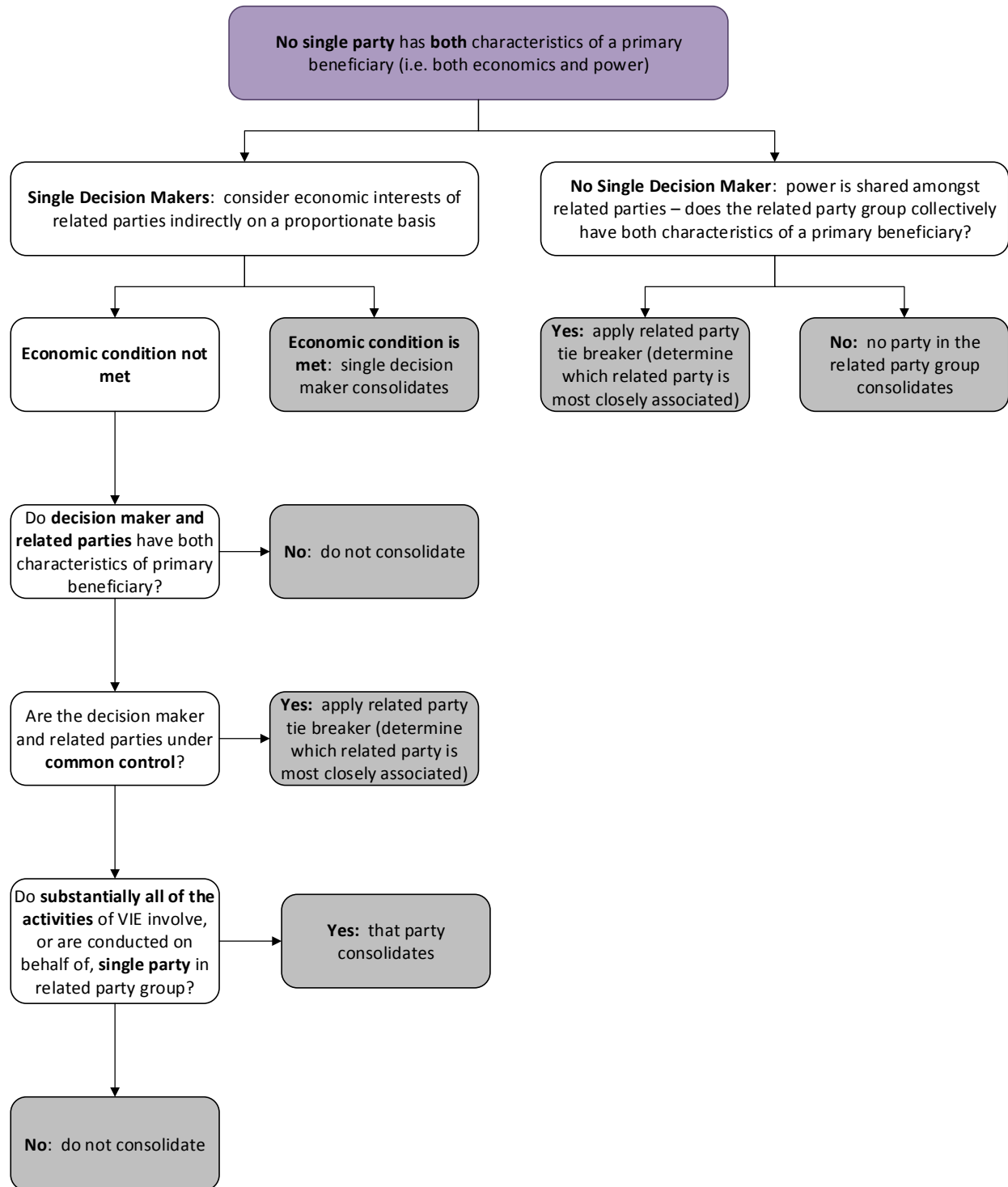
In this scenario, for purposes of determining whether the management fee received by the reporting entity is a variable interest, the reporting entity would have a 21 percent interest in the VIE (1 percent direct interest + 20 percent indirect interest under common control). However, for purposes of determining whether the reporting entity is the primary beneficiary, the reporting entity would have a 3 percent interest in the VIE (1 percent direct + 10 percent of a 20 percent indirect interest). Additionally, if the reporting entity did not have an investment in Subsidiary A, it would not consider Subsidiary A's investment in the VIE without regard as to whether the reporting entity and Subsidiary A are under common control.



Impact of related parties when no single party has both characteristics of a primary beneficiary

When determining which, if any, of the parties holding variable interests in a VIE is the primary beneficiary, the reporting entity may determine that no single party has both characteristics of a primary beneficiary—that is, no entity meets the power and benefit criteria in ASC 810-10-25-38A. When such a determination is reached, the reporting entity should then consider the impact of related parties, which may manifest in two ways, depending on whether there is a single decision maker for the VIE or whether power is shared. The analysis to be performed is described in detail in Step 6.4 and is illustrated in the chart on the following page.

There is one key distinction in how variable interests held by related parties are considered for purposes of determining whether a decision maker or service provider fee is a variable interest and when evaluating the impact of related parties when no single party has both characteristics of a primary beneficiary. As noted above, when considering whether a decision maker fee received by the reporting entity is a variable interest, variable interests held by related parties are considered on an indirect and proportionate basis, unless the related party is under common control with the reporting entity. If the related party is under common control with the reporting entity, the related party's variable interests are considered to be direct variable interests of the reporting entity in the VIE. However, when considering the impact of related parties when no single party has both characteristics of a primary beneficiary, variable interests of the decision maker's related parties are always considered only on an indirect and proportionate basis, without regard as to whether the related party is under common control with the reporting entity.



Appendix D

Presentation and disclosure requirements

This appendix outlines the presentation and disclosure requirements in ASC 810-10, *Consolidation: Variable Interest Entities* subsections.

Presentation requirements

The primary beneficiary of a VIE must separately present both of the following on the face of its balance sheet:

- Assets of a consolidated VIE that can be used only to settle obligations of the VIE
- Liabilities of a consolidated VIE for which creditors do not have recourse to the primary beneficiary's general credit

Disclosure objectives

The objectives of the disclosures under ASC 810-10, *Variable Interest Entities* subsections, are to provide financial statement users with an understanding of the following:

- The significant judgments and assumptions made in determining whether the reporting entity must consolidate a VIE and/or disclose information about its involvement with a VIE
- The nature of restrictions on a consolidated VIE's assets and the carrying amounts of such assets in the consolidated financial statements
- The nature of, and changes in, the risks associated with a reporting entity's involvement with the VIE
- How the reporting entity's involvement with the VIE affects the reporting entity's balance sheet, income statement, and cash flows

A reporting entity must provide disclosures necessary to meet those objectives. Therefore, it should make disclosures in addition to those specifically required if facts and circumstances indicate that additional disclosures are necessary to meet the disclosure objectives.

Aggregation

A reporting entity may aggregate the disclosures required under ASC 810-10 for similar entities only if separate reporting would not provide more useful information to users. The reporting entity must also disclose how similar entities were aggregated. The disclosures should distinguish between (1) VIEs that are consolidated, and (2) VIEs that are not consolidated because the reporting entity is not the VIE's primary beneficiary but holds a variable interest in the entity.

If disclosures required by ASC 810-10, as amended by ASU 2009-17, are presented in more than one note to the financial statements, the notes must be cross-referenced to other notes in the financial statements that provide the disclosures required by the ASC 810-10, *Variable Interest Entities* subsections, guidance for similar entities.

Specific disclosure requirements for the primary beneficiary

Under ASC 810-10, the primary beneficiary of a VIE must disclose the following information:

- The reporting entity's methodology for determining whether it is the primary beneficiary of a VIE, including, but not limited to, significant judgments and assumptions made

- The primary reasons for a change in a previous conclusion about whether a VIE should be consolidated, if applicable, and the effect of this change on the reporting entity's financial statements
- Whether the reporting entity provided support to the VIE during the period presented when it was not contractually obligated to do so, or if it intends to provide that support. If so, the type and amount of support (including situations where the reporting entity helped the VIE to obtain another type of support) and the reasons for providing it should also be disclosed.
- Both qualitative and quantitative information about the reporting entity's involvement with the VIE (considering both explicit arrangements and implicit variable interests), including, but not limited to, the nature, purpose, size, and activities of the VIE and how the VIE is financed
- The carrying amount and classification of the VIE's assets and liabilities that have been consolidated, including qualitative information about the relationships between those assets and liabilities
- The fact that there is a lack of recourse if creditors or beneficial interest holders of a consolidated VIE do not have recourse to the general credit of the primary beneficiary
- The terms of any explicit arrangements or implicit variable interests that could require the reporting entity to provide support to the VIE, and a description of the events or circumstances that could expose the reporting entity to a potential loss

Disclosure exception for primary beneficiary that holds a majority voting interest in VIE

The primary beneficiary is not required to provide the specific disclosures described above if all of the following conditions are met:

- The primary beneficiary holds a majority of the VIE's voting equity interest.
- The VIE is a "business," as defined by the guidance in ASC 805, *Business Combinations*.
- The VIE's assets can be used for purposes other than the settlement of the VIE's obligations.

However, the primary beneficiary of a VIE that is a business must provide the disclosures required by ASC 805. The primary beneficiary of a VIE that is not a business must disclose the amount of gain or loss recognized on initial consolidation of the VIE.

Specific disclosure requirements for a reporting entity holding a variable interest in a VIE

A reporting entity that holds a variable interest in a VIE, but is not the VIE's primary beneficiary, must disclose the following information:

- The reporting entity's methodology for determining whether it is the primary beneficiary of a VIE, including, but not limited to, significant judgments and assumptions made
- The primary reasons for a change in a previous conclusion about whether a VIE should be consolidated, if applicable, and the effect of this change on the reporting entity's financial statements
- Whether the reporting entity provided support to the VIE during the periods presented when it was not contractually obligated to do so or if it intends to provide that support. If so, the type and amount of support (including situations where the reporting entity helped the VIE to obtain another type of support) and the reasons for providing it should also be disclosed.
- Both qualitative and quantitative information about the reporting entity's involvement with the VIE (considering both explicit arrangements and implicit variable interests), including, but not limited to, the nature, purpose, size, and activities of the VIE, and how the VIE is financed

- The carrying amount and classification of the VIE's assets and liabilities that are included in the entity's balance sheet related to the entity's variable interest in the VIE
- The entity's maximum exposure to loss through its involvement with the VIE, including how that exposure is determined and its sources. If the exposure cannot be quantified, that fact should be disclosed along with the reasons why.
- A table showing the carrying amount of the assets and liabilities related to the reporting entity's variable interests in the VIE and the associated maximum exposure to loss, supplemented by sufficient qualitative and quantitative information to explain the differences between those two amounts, including, but not limited to, the terms of arrangements (covering both explicit arrangements and implicit variable interests that might require the reporting entity to provide financial support) and events or circumstances that could expose the reporting entity to a loss
- Descriptions of liquidity arrangements, guarantees, or other commitments by third parties that might affect the fair value or risk related to the reporting entity's variable interest in a VIE. Such disclosures are encouraged but not required.
- Significant factors considered and judgments made in determining that the power to direct the activities that most significantly impact a VIE's economic performance is shared

Entities subject to the scope exception in ASC 810-10-15-17(c)

A reporting entity must make the following disclosures if it does not apply the guidance in ASC 810-10, *Variable Interest Entities* subsections, to a VIE or to a potential VIE because the VIE was created before December 31, 2003 and certain information cannot be obtained, as described in ASC 810-10-15-17(c):

- The number of entities meeting the scope exception in ASC 810-10, *Variable Interest Entities* subsections, and the reason the necessary information is unavailable
- The nature, purpose, size (if available), and activities of the entities, and the nature of the reporting entity's involvement with them
- The reporting entity's maximum exposure to loss as a result of its involvement with the entities
- Appropriate measures of activity (such as income, expenses, purchases, or sales) between the reporting entity and the entities for all income statement periods presented. Such information for prior periods presented in the first set of financial statements to which this requirement applies must be provided only if it is practicable to do so. (This requirement was initially established by the December 2003 revision of FASB Interpretation 46, *Consolidation of Variable Interest Entities*.)

Appendix E

Private company accounting alternative to the VIE guidance for common-control leasing arrangements

In March 2014, the FASB released its third U.S. GAAP alternative standard for private companies, [ASU 2014-07, Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements – a consensus of the Private Company Council](#), based on a consensus reached by the Private Company Council (PCC). The guidance offers private companies that meet certain conditions an exemption from the existing requirement to evaluate a lessor for consolidation in certain common-control leasing arrangements, using the VIE guidance in ASC 810, *Consolidation*.

Many owners of private companies establish a separate entity to own assets that are then leased to the private company. These arrangements are often made for tax, estate-planning, and legal liability purposes, as well as for other reasons. For example, the sole owner of a manufacturing company might also own a building in a separate legal entity that is leased to the manufacturing company. As a variation, the owner might instead establish a trust in the name of its heirs to own the entity for estate-planning purposes. Often these arrangements result in the private company having to consolidate the lessor entity under the guidance in ASC 810.

The PCC took on this issue due to feedback from stakeholders, which indicated that consolidating a lessor entity under common control with the lessee often does not provide meaningful information to financial statement users, who frequently request a consolidating schedule to understand the effects of consolidating the lessor.

Deciding whether to elect the PCC alternative

General considerations in choosing to apply private company alternatives

Private companies should carefully consider whether to adopt accounting alternatives that are not available to public business entities. Refer to NDS 2014-01, "[Moving closer to private company GAAP alternatives](#)," for additional information about the definition of a *public business entity* and other considerations for entities in deciding whether to adopt private company accounting alternatives.

Considerations in choosing not to consolidate a lessor under common control

In determining whether to make an accounting policy election not to apply the VIE guidance in ASC 810, private company lessees should consider the following factors:

- *Whether the lessee's debt covenants would need to be amended with its lenders.* For example, a lessee might have previously amended debt covenants due to the consolidation of a lessor under common control.
- *Whether the lease arrangement would be classified as a capital lease or an operating lease if the lessee were no longer required to consolidate the lessor.* For example, a guarantee by a lessee of debt that has recourse only to the leased asset would constitute a guarantee of the residual value of the asset by the lessee, which should be considered when classifying the lease under ASC 840, *Leases*. In addition, the minimum lease term would include any renewal options during which a guarantee by the lessee of lessor debt directly or indirectly related to the leased asset is expected to be in effect.

If the lease were considered a capital lease, that may be a less favorable financial reporting answer in the eyes of many private companies than simply consolidating the VIE. Instead of simply

consolidating the leased asset, the leased asset would be still be considered an asset of the reporting entity, with a corresponding financial liability based on the lease terms, if the lease were considered a capital lease.

- *Whether the lessee previously transferred the leased asset to the lessor.* Although the lessee may no longer need to consolidate the lessor, given the required retrospective application of the final ASU, the lessee would need to evaluate whether the transaction meets the requirements for sale and leaseback accounting. Transactions with continuing involvement, such as debt guarantees by a related party, repurchase options, or other involvement, frequently do not qualify for sales accounting. The seller/lessee would account for that transaction using either the deposit method or the financing method, whichever is more appropriate under ASC 360-20, *Property, Plant, and Equipment: Real Estate Sales*.

Scope

The accounting policy election offered in ASC 810-10-15-17AA through 15-17C only applies to private companies that meet certain conditions (see the section below for those conditions). “Private companies,” as defined in the Master Glossary of the Codification, include entities other than public business entities, not-for-profit entities, and employee benefit plans within the scope of ASC 960, *Plan Accounting – Defined Benefit Pension Plans*; ASC 962, *Plan Accounting – Defined Contribution Pension Plans*; or ASC 965, *Plan Accounting – Health and Welfare Benefit Plans*.

Arrangements that qualify for the accounting policy election

A private company lessee reporting entity (lessee) that makes the accounting policy election would not be required to evaluate a lessor legal entity (lessor) under the VIE consolidation guidance in ASC 810-10 if all of the following four conditions are *continuously* met:

- The lessee and lessor are under common control.
- A lease arrangement exists between the lessor and lessee.
- Substantially all activities between the lessee and lessor are related to leasing activities (including supporting leasing activities).
- If the lessee explicitly guarantees the debt of the lessor or provides collateral (support) for any obligation of the lessor, then the value of the leased asset must exceed the principal amount of the debt at the later of (1) the inception of the support, (2) the most recent lessor refinancing, or (3) the new debt arrangement.

A private company that makes the accounting policy election must apply it to all current and future common-control leasing arrangements. Those arrangements would be evaluated under the above conditions on an arrangement-by-arrangement basis.

Deletion of implicit variable interest examples in ASC 810-10-55

ASU 2014-07 supersedes the implementation guidance in ASC 810-10-55-87 through 55-89 related to implicit variable interests. However, we believe such guidance would be helpful when an arrangement does not meet the conditions to apply the accounting alternative and for private companies that choose not to make an accounting policy election to apply the accounting alternative. In addition, we believe it would be helpful in evaluating whether an implicit

guarantee exists for purposes of the new disclosure requirements for entities that apply the accounting alternative.

Those superseded paragraphs are presented below for the sake of convenience:

ASC 810-10-55-87 – *This Example illustrates the guidance in paragraphs 810-10-25-48 through 25-54 (ASC references are prior to the adoption of ASU 2014-07).*

ASC 810-10-55-88 – *One of the two owners of Manufacturing Entity is also the sole owner of Leasing Entity, which is a VIE. The owner of Leasing Entity provides a guarantee of Leasing Entity's debt as required by the lender. Leasing Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph 810-10-55-39. The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Entity and Leasing Entity. (ASC references are prior to the adoption of ASU 2014-07)*

ASC 810-10-55-89 – *Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity. Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity as a result of the leasing arrangement and the relationship between it and the owner of Leasing Entity. For example, Manufacturing Entity would be considered to hold an implicit variable interest in Leasing Entity if Manufacturing Entity effectively guaranteed the owner's investment in Leasing Entity. The guidance in paragraphs 810-10-25-48 through 25-54 shall be used only to evaluate whether a variable interest exists under the Variable Interest Entities Subsections and shall not be used in the evaluation of lease classification in accordance with Topic 840. Paragraph 840-10-25-26 addresses leases between related parties. Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent the owner's guarantee of Leasing Entity's debt from being called on, or Manufacturing Entity may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Entity's debt guarantee. The determination as to whether Manufacturing Entity is effectively guaranteeing all or a portion of the owner's investment or would be expected to make funds available and, therefore, an implicit variable interest exists, shall take into consideration all the relevant facts and circumstances. Those facts and circumstances include, but are not limited to, whether there is an economic incentive for Manufacturing Entity to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether Manufacturing Entity acting as a guarantor or making funds available would be considered a conflict of interest or illegal. (ASC references are prior to the adoption of ASU 2014-07)*

Common control

The FASB Codification does not include a definition of "common control." The PCC decided not to include a definition of common control in ASU 2014-07, despite constituent requests to provide such a definition. The PCC reasoned that including a definition would have broader implications and would potentially have delayed issuance of the final ASU. The PCC noted, however, that the term "common control" is used in ASC 805, *Business Combinations*, and that public companies generally apply the guidance in EITF Issue 02-5, "Definition of 'Common Control' in Relation to FASB Statement No. 141," although this issue was never finalized or codified. The PCC and the FASB also observed that for purposes of applying

the accounting alternative, common control would be broader than the SEC staff observations included in EITF Issue 02-5.

The following situations generally would be considered common-control arrangements under the accounting alternative:

- An individual or enterprise holds more than 50 percent of the voting ownership interest in each the lessee and the lessor.
- A group of individuals holds more than 50 percent of the voting ownership interest of each the lessee and lessor, and written evidence contemporaneously exists of an agreement to vote a majority of the entities' shares in concert.
- Immediate family members (such as married couples, children, and grandchildren) hold more than 50 percent of the voting ownership interest of each entity (lessor & lessee), provided that there is no evidence that those family members will vote their shares in any way other than in concert.

Note that ownership interests may be held in trusts.

Other situations, such as where Individual A and Individual B own 75 percent and 25 percent, respectively, of the lessor, as well as 25 percent and 75 percent, respectively, of the lessee, would not qualify as common control.

Leasing activities

Implementation guidance within ASC 810-10-55-9 and 810-10-55-205AJ through 55-205AR suggests that the following activities would be considered leasing activities of the lessee:

- Providing guarantees or collateral to a lender of the lessor for debt related to the leased asset
- Paying property taxes on the leased asset
- Negotiating financing on the leased asset
- Functioning as an obligor of a joint and several liability arrangement related to the lessor's debt that is secured by the leased asset(s)
- Maintaining the leased asset
- Paying the lessor's income taxes when the only asset owned by the lessor is being leased either by only the private company or by both the private company lessee and an unrelated party
- Performing bookkeeping activities related to the lessor

The following would not be considered leasing activities under the accounting alternative:

- Paying the lessor's income taxes on income generated from assets not being leased by the private company lessee
- Entering into purchase commitments other than for acquisition or support of the leased asset
- Providing guarantees or other collateral to the lessor unrelated to the leased assets
- Having substantial other activities between the lessee and lessor (for example, purchase and supply agreements for products)

Leasing activities

In evaluating leasing activities, ASC 810-10-55-205AO and 55-205AP provide a distinction between assets owned by the lessor that are leased to the reporting private company and those that are not leased to the reporting company. For example, if a lessor leases a portion of a ten-floor office building to an entity under common control and the remainder to third parties, a guarantee by the lessee of debt on the entire building (including portions not leased) would be considered leasing activities.

However, if the lessor owns two five-story office buildings and leases one building to a lessee under common control and the other building to third parties, a guarantee by the lessee of debt on both buildings would not be considered leasing activities.

Disclosures

ASC 810-10-50-2AD requires the following disclosures for lessor legal entities to which the private company applies the accounting alternative:

- Amount and key terms of liabilities (for example, debt, asset retirement obligations, and environmental liabilities) recognized by the lessor entity that expose the lessee to providing financial support to the lessor
- Qualitative descriptions of circumstances not recognized in the lessor's financial statements that expose the lessee to providing financial support to the lessor (for example, certain commitments and contingencies)

A private company lessee should consider its exposure through implicit guarantees when disclosing this information. The determination of whether an implicit guarantee exists is based on facts and circumstances, including such factors as

- Previous support provided by the lessee to the lessor
- Incentives to provide support (for example, an economic incentive for the lessee to guarantee debt or to make funds available beyond the contractual lease term)
- Impediments to providing support (for example, if providing support by the lessee to the lessor is prohibited by the lessee's debt arrangement or considered illegal or a conflict of interest)

The above disclosures should be combined with, or cross-referenced to, disclosures required by other U.S. GAAP, such as the disclosures in ASC 460, *Guarantees*; ASC 840, *Leases*; and ASC 850, *Related Party Disclosures*.

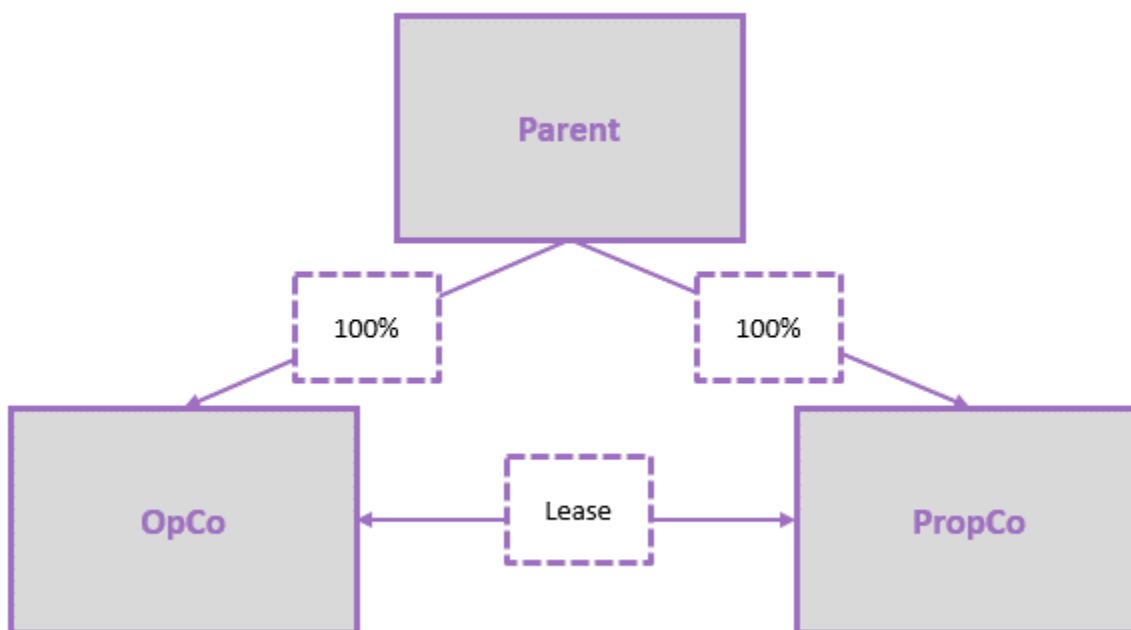
Appendix F

Illustrative examples of common VIE arrangements

Example of common-control leasing

Background

Parent Entity is an operating commercial entity. Parent concludes that it needs to purchase a new building to house its operations, and finances the purchase of a building with debt. In order to facilitate the transaction, Parent creates two new, wholly owned entities: Operating Company (OpCo) that houses all of the employees and business operations formerly of Parent, and Property Company (PropCo) that owns the new building and is obligated on the building's mortgage (the mortgage is guaranteed by Parent). PropCo's only activity is leasing the building to OpCo, which occupies 100 percent of the building. The lease contains no explicit guarantees or purchase options and is otherwise on market terms. The relationship between Parent, OpCo, and PropCo is structured as follows:



For the purpose of this illustration, OpCo is the reporting entity and is considering whether it should consolidate PropCo.

Analysis

What is the purpose and design of PropCo?

PropCo is designed to finance the purchase of the building used in the business operations of OpCo.

Is PropCo a separate legal entity?

Yes.

What are the variable interests in PropCo?

The equity interests held by Parent are variable interests, although they may not be considered equity at risk if Parent's investment in PropCo is effectively guaranteed by OpCo.

The leasing arrangement between PropCo and OpCo should be analyzed to determine if it is a variable interest or contains implicit variable interests. In this example, OpCo should consider whether it holds an implicit variable interest in PropCo as a result of the leasing arrangement between OpCo and PropCo—specifically, whether OpCo, as the operating entity, has effectively guaranteed Parent's investment in PropCo. OpCo would consider whether there is an economic incentive for OpCo to act as a guarantor and to make funds available to PropCo in the event PropCo needs additional funds to service its debt, maintain the building, or renew the lease.

For instance, if the debt on PropCo is variable-rate debt, and interest rates rise to the point where the lease payments are no longer sufficient to service the debt, is it likely that the leasing agreement would be amended to allow PropCo to continue to meet its debt obligations? Or, if the building needs significant repairs that cost in excess of PropCo's cash reserves, would the leasing agreement be amended to make funds available to pay for the repairs? What would happen if OpCo is obligated to renew the lease for terms that may not be in OpCo's best interest?

In this example, there is an economic incentive for OpCo to act as a guarantor in such circumstances, because if PropCo defaults on its debt or cannot make necessary repairs, then OpCo could not run its business. Also, OpCo is effectively obligated to renew the lease to assure Parent's return on investment and to protect Parent from losses that may be associated with leasing the property to third parties or marketing a vacant property. OpCo therefore concludes that it has an implicit variable interest in PropCo.

Does the reporting entity qualify for any scope exceptions?

OpCo may be eligible for the Private Company Counsel (PCC) alternative regarding the VIE consolidation rules (see Appendix E). However, for the purpose of this illustration, presume that OpCo did not elect the PCC alternative, even if it was eligible to do so.

Is PropCo a VIE?

a. Does PropCo have insufficient equity at risk?

Because Parent guarantees PropCo's debt, and because OpCo guarantees Parent's investment in PropCo, PropCo does not have sufficient equity at risk and is therefore a VIE.

b. Do the equity holders as a group lack the power to control the activities that most significantly impact the economic performance of PropCo?

The key activity for PropCo is leasing the building to OpCo. The terms of the leasing arrangement are typically dictated by (1) the terms of the debt arrangement, (2) the cash flow needs of PropCo (for maintenance and other expenses/costs that arise), and (3) OpCo's ability to generate sufficient cash flow. While both entities are under common control, such a set of facts and economic incentives suggests that the key activity for PropCo is not controlled through equity rights, but rather through the leasing arrangement itself. Therefore, PropCo is a VIE.

Is the entity structured with nonsubstantive voting rights? That is, are the voting rights of some investors not proportionate to their obligation to absorb expected losses or receive residual returns, and are substantially all of the entity's activities conducted on behalf of, or involve, an investor (including its related parties) with disproportionately few voting rights?

OpCo effectively guarantees Parent's investment in PropCo, and, as such, its voting rights via its equity interests and its obligation to absorb expected losses and receive residual returns are not proportionate. In addition, substantially all activities are performed on behalf of Parent and its related parties. Accordingly, PropCo is a VIE.

Who is the primary beneficiary of the PropCo?

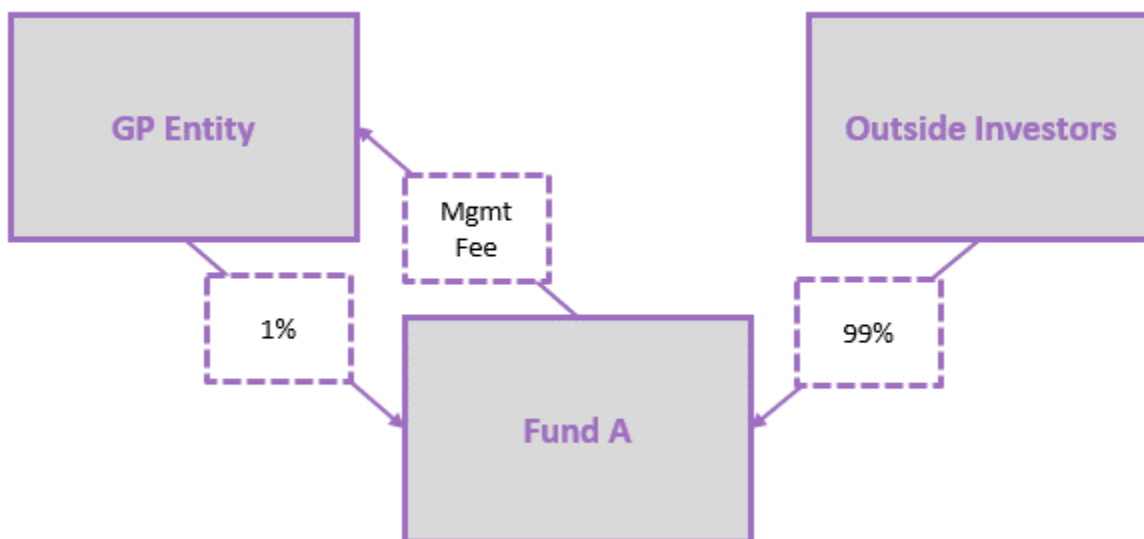
As the lessee, OpCo controls the activities that most significantly impact economic performance and therefore meets the "power" characteristic of the primary beneficiary in ASC 810-10-25-38A.

Regarding the "economic" characteristic, OpCo has a variable interest in PropCo that is potentially significant in the form of an implicit guarantee via the leasing arrangement. Accordingly, OpCo meets both criteria to be considered the primary beneficiary of PropCo and would therefore consolidate PropCo.

Example of investment fund/fund manager

Background

Fund A is a limited liability partnership that meets the definition of an "investment company" under ASC 946, *Financial Services – Investment Companies*, created to hold liquid investments in debt and equity securities. Fund A has two classes of equity interests—a general partner interest and limited partner interests—and is structured as follows:



Fund A's general partner (the GP) owns 1 percent of Fund A and has all rights typically associated with general partners. The GP also serves as the fund manager, making all investment decisions for Fund A, for which the GP receives a fee. The total management fee is a combination of a management fee of 1 percent of total assets and an incentive fee of 20 percent of total returns over an annual hurdle rate. The incentive fee is structured as a carried interest—that is, the GP is credited with a capital allocation equal to the value of its incentive fee. The incentive fee "crystalizes" (the point at which the fee cannot be

clawed back) at the end of each year, and the GP may annually withdraw up to 80 percent of its carried interest crystallized in the prior year. The GP generally withdraws all such available funds at year-end.

Accounting for carried interests

In Fund A's financial statements, carried interests are considered compensation to the GP (an expense of the fund) and a component of the GP's capital account as the carried interest is earned. No portion of the carried interest earned by the GP is a liability in Fund A's financial statements until the GP requests a withdrawal to which the GP is entitled, at which point it becomes a liability to Fund A until paid.

Fund A's limited partners (the LPs) are generally passive. LPs can remove the GP as investment manager only in the event that the GP is found to be in breach of the limited partnership agreement, and they have no rights with regard to the decisions of the GP. The GP and LPs share returns on a pro rata ownership basis, after payment of the GP's fee for service as investment manager. The GP is not a related party with any of the LPs.

For the purposes of this analysis, assume that the GP is the reporting entity.

Analysis

What is the purpose and design of the entity?

Fund A is designed as an investment company and was created to expose investors to the risks and rewards of ownership of liquid debt and equity securities (interest, dividends, and capital appreciation) by providing professional investment management services.

Is Fund A a separate legal entity?

Yes. Fund A is organized as a limited liability partnership.

What are the variable interests in Fund A?

The GP and LP interests are variable interests in Fund A.

The fee the GP receives as investment manager may or may not be a variable interest, depending on the evaluation of the following criteria in ASC 810-10-55-37:

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

The GP is providing professional investment management services, so the fee is for services provided. As for whether the fee is commensurate with the level of effort, presume that the fee is customary for funds that are similar to Fund A and is therefore considered commensurate with the level of effort.

- b. *The decision maker or service provider does not hold other interests in the VIE that individually, or in 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.*

The GP does hold another variable interest (its equity stake), but at 1 percent, with no related-party interest considered on an indirect and proportionate basis since the GP is not related to any LPs, the variable interest would not absorb more than an insignificant amount of the VIE's expected variability.

- c. *The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.*

For this example, presume that a fee based on a 20 percent hurdle rate is customary for this type of arrangement for managers of funds similar to Fund A.

We believe that the carried interest would represent a variable interest only once crystalized and added to the GP's equity interest in Fund A (that is, once it is "reinvested").

Does the reporting entity qualify for any scope exceptions?

Fund A is not eligible for any scope exceptions, nor is it a private company with a qualifying lease with an entity under common control so that it can avail itself of the Private Company Counsel alternative regarding the VIE consolidation rules (see Appendix E).

Is Fund A a VIE?

- a. *Does Fund A have insufficient equity at risk?*

The reporting entity would likely conclude that Fund A has sufficient equity at risk, as it funds its activities solely through equity capital and retained/reinvested earnings, and requires no additional subordinated financial support.

- b. *Do the LPs have substantive kick-out rights or participating rights exercised by a simple majority (through voting rights) or a lower threshold such that the LP would be a voting rights entity?*

No. As noted above, the LPs can remove the investment manager only if it is found in breach of the limited partnership agreement, making its rights protective in nature. The LPs have no rights regarding the investment manager's decisions otherwise.

Note: In some funds of this type, the LPs may have certain rights regarding the investment manager's activities. These rights should be analyzed to see if they constitute substantive participating rights. For instance, the investment manager might be required to obtain a simple majority approval from the LPs for any transaction whose value exceeds 10 percent of the fund's total assets. For funds that deal primarily in exchange-traded debt and equity investments, this might not be a substantive right, as few transactions would be expected to exceed 10 percent of the fund's total assets. However, for funds that take a lower number of high-value positions, it is possible that many of the fund's transactions are more than 10 percent of total assets of the fund. In that case, the rights might be considered substantive participating rights, which would make the fund a voting rights entity that is outside the scope of the VIE model.

- c. *Do the equity holders, as a group, lack the power to control the activities that most significantly impact the economic performance of Fund A?*

The key activities for Fund A are the investment decisions: in what entities should Fund A invest and in what form (debt, equity, or other forms). Those decisions, while made by the GP (who is an equity holder), are not made through the GP's equity rights, but rather through its rights as investment manager. Therefore, this condition is met, and Fund A is a VIE.

- d. *Is the entity structured with nonsubstantive voting rights? That is, are the voting rights of some entities not proportionate to their obligation to absorb expected losses or receive residual returns, and are substantially all of the entity's activities conducted on behalf of, or involve, an entity with disproportionately few voting rights?*

While there are not proportionate voting rights, which satisfies the first criteria, the second criteria is not met because substantially all of the activities of the fund are not conducted on behalf of, or involve, an entity with disproportionately few voting rights.

Who is the primary beneficiary?

The GP, as investment manager, controls the activities that most significantly impact economic performance; however, if the investment manager fee arrangement is not a variable interest, the investment manager would be acting as an agent on behalf of the LP investors and therefore would not meet the “power” criteria of the primary beneficiary in ASC 810-10-25-38A. If the investment manager fee arrangement is a variable interest, the GP would control the activities that most significantly impact economic performance and would therefore meet the “power” criteria of the primary beneficiary in ASC 810-10-25-38A.

Regarding the “economic” criteria, the answer may depend on the impact of the carried interest on the GP's equity interest. At 1 percent, the GP's equity interest does not represent an obligation to absorb losses, or the right to receive benefits, in Fund A that could potentially be significant. However, as the carried interest is crystalized and increases the GP's equity interest (that is, it is “reinvested”), it is possible that, at some point, the GP's equity at risk may represent an obligation to absorb losses or the right to receive benefits in Fund A that could potentially be significant.

It is also important to note that for the purposes of evaluating whether the GP meets the economic criteria in ASC 810-10-25-38A, Paragraphs 25-38I – 25-38J state that the fee would be excluded from the analysis as long as the fee (1) is customary (similar to the fee in this example), and (2) does not expose the decision maker to risk of loss (in this example, the incentive fee does not expose the GP to risk of loss until it is crystalized).

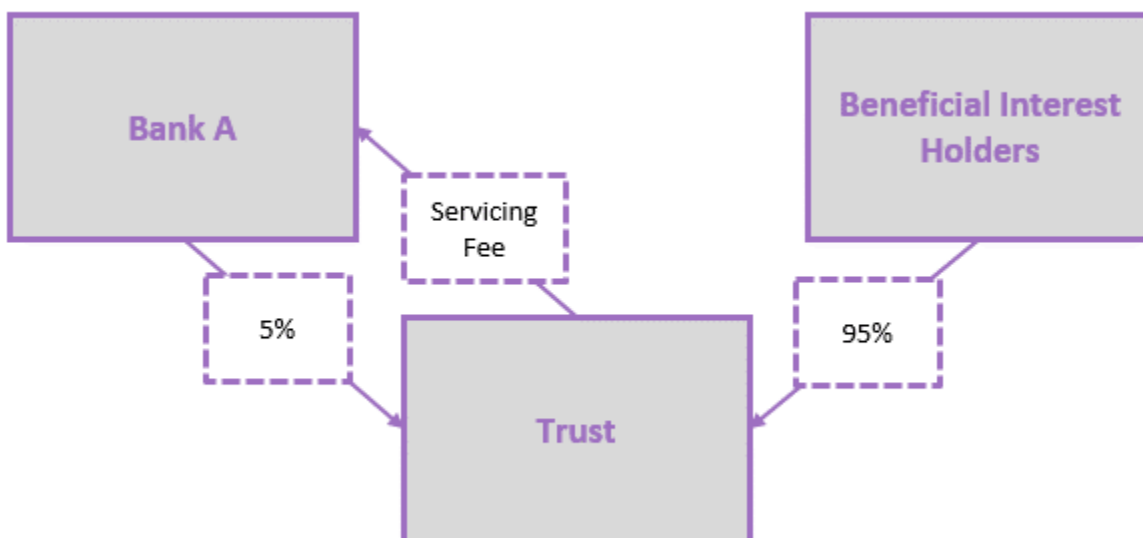
Accordingly, unless and until the GP's equity interest increases to the point that its investment manager fee arrangement is a variable interest and represents an obligation to absorb losses, or a right to receive benefits, in Fund A that could potentially be significant, neither the GP nor the LPs would meet both the power and benefits criteria in ASC 810-10-25-38A. Also, as noted above, there are no related parties to consider. As a result, Fund A would have no primary beneficiary, and no one would consolidate Fund A.

Example of securitization

Background

Bank A (the reporting entity) originates mortgage loans and sells the loans to a securitization trust it sponsors. The loans are sold as whole loans with servicing retained and meet the derecognition criteria in ASC 860, *Transfers and Servicing*. The securitization trust then sells beneficial interests in the cash flows of the loans to outside investors in three “tranches”: the senior tranche, the senior-subordinated tranche, and the most subordinated tranche. As proceeds for the sale of the loans, Bank A receives both cash and a beneficial interest in the most subordinated tranche of the securitization trust's beneficial interests. The Bank owns 5 percent of the most subordinated tranche.

Bank A receives a fee for its servicing of the loans in the securitization trust that is customary and at market terms.



Analysis

What is the purpose and design of the entity?

The securitization trust is designed to purchase loans and pass on the credit risk of those loans to its beneficial interest holders.

Is the securitization trust a separate legal entity?

Yes. The securitization trust is organized as a trust, which is a separate legal entity.

What are the variable interests in the securitization?

The beneficial interests are variable interests in the securitization.

The fee Bank A receives as servicer may or may not be a variable interest, depending on the evaluation of the following criteria in ASC 810-10-55-37:

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

The Bank is providing services to the securitization trust in the form of servicing the loans in the trust, so the fee is for services provided. Presume that the fee is customary for similar securitization trusts and is therefore commensurate with the level of effort.

- b. *The decision maker or service provider does not hold other interests in the VIE that individually, or in 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.*

The Bank's 5 percent interest in the most subordinated tranche of beneficial interest is another variable interest and exposes the Bank to more than insignificant variability in the securitization trust, since beneficial interests are in the most subordinated tranche. Therefore, the servicing fee would be considered a variable interest in the securitization trust.

- c. *The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.*

The fee is customary for this type of securitization trust compared to market terms.

Does the reporting entity qualify for any scope exceptions?

Bank A is not eligible for any scope exceptions (note that the business scope exception specifically prohibits securitization vehicles from using that exception), nor is it a private company with a qualifying lease with an entity under common control so that it can avail itself of the Private Company Counsel alternative regarding the VIE consolidation rules (see Appendix E).

Is the securitization trust a VIE?

- a. *Does the securitization trust have insufficient equity at risk?*

The reporting entity would likely conclude that the securitization trust does not have sufficient equity at risk because the subordination of beneficial interest provides credit support to the more senior beneficial interest holders, effectively acting as a guarantee by the more subordinated beneficial interest holders to the benefit of the more senior beneficial interest holders. That structure is typically considered evidence that the equity at risk is not sufficient to finance its activities and that the securitization trust is therefore a VIE.

- b. *Do the equity holders, as a group, lack the power to control the activities that most significantly impact the economic performance of Bank A?*

The key activities for the securitization trust are the servicing of problem loans: executing problem loan workouts, foreclosing on collateral, and related activities. Those decisions are made through the Bank's rights as loan servicer. Therefore, this condition is met, and the securitization trust is a VIE.

- c. *Is the entity structured with nonsubstantive voting rights? That is, are the voting rights of some entities not proportionate to their obligation to absorb expected losses or receive residual returns, and are substantially all of the entity's activities conducted on behalf of, or involve, an entity with disproportionately few voting rights?*

As the beneficial interest holders do not have voting rights, the first criteria is met. However, the second criteria is not met, as substantially all of the activity is not conducted on behalf of, or involves, an investor with disproportionately few voting rights.

Who is the primary beneficiary?

The Bank, as loan servicer, controls the activities that most significantly impact economic performance and therefore meets the "power" characteristic of the primary beneficiary in ASC 810-10-25-38A.

Note: In some securitization trusts, certain beneficial interest holders may have the ability to kick-out the loan servicer. Such kick-out rights should be evaluated to determine if they are substantive. If such kick-out rights are in fact substantive, then the Bank would not meet the power criteria.

Regarding the "economic" criteria, the Bank meets the criteria by virtue of its interest in the subordinated beneficial interest tranche. Accordingly, Bank A meets both criteria and is therefore considered the primary beneficiary of the securitization trust and would consolidate the trust.

Note: If Bank A did not hold the interest in the subordinated tranche of beneficial interest and if the servicing fee was on market terms, the servicing fees would not be a variable interest, and the Bank would not be the primary beneficiary.

It is also important to note that for the purposes of evaluating whether the Bank meets the economic criteria in ASC 810-10-25-38A, Paragraphs 25-38I – 25-38J state that the fee would be excluded from the analysis as long as the fee (1) is customary (similar to the fee in this example), and (2) does not expose the decision maker to risk of loss. The fee does not expose the Bank to risk of loss and is considered a market fee, and would therefore not be considered in evaluating whether the Bank meets the economic criteria.