KPMG

Consolidation

Handbook

US GAAP

November 2023

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Contents

Challenging and sometimes perplexing

Consolidated financial statements are presumed to be more meaningful than separate statements – based on the foundational principle that consolidated statements are usually needed for a fair presentation when one company controls another.

This presumption and foundational principle were established in 1959, and while the basic principles endure, today's consolidation analysis has evolved dramatically since then. Sweeping changes in 2003 introduced the variable interest entity consolidation model, and 2007 brought highly anticipated guidance on accounting for noncontrolling interests.

The judgments about what it means to have a controlling financial interest and how consolidated financial statements are prepared have become increasingly challenging and sometimes perplexing.

This Handbook provides an in-depth look at consolidation and consolidation procedure. It guides you through some of the most complex literature in US GAAP and provides insight and examples to assist you in making the critical judgments necessary to execute on the principles of consolidation.

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About this publication

The purpose of this Handbook is to assist you in applying the standard on consolidation, Topic 810, and the requirements of other standards that play a role in consolidation.

Organization

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice. We include examples to explain key concepts.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples:

- 810-10-25-14 is paragraph 25-14 of ASC Subtopic 810-10
- S-X Rule 5-02 is Rule 5-02 of SEC Regulation S-X
- SAB Topic 12.C is SEC Staff Accounting Bulletins Topic 12.C
- TQA 6140.10 is section 6140.10 of the AICPA's Technical Questions and Answers
- FAS 141.24 is paragraph 24 of FASB Statement No. 141
- ASU 2015-02.BC.A35 is paragraph A35 in the basis for conclusions of FASB Accounting Standards Update (ASU) No. 2015-02
- 2016 AICPA Conf is the 2016 AICPA National Conference on Current SEC and PCAOB Developments. These references are hyperlinked to the source material on the SEC's website
- AAG-INV.7.11 is paragraph 11 of chapter 7 of the AICPA's Audit and Accounting Guide, Investment Companies
- SSAP 56.2 is paragraph 2 of Statement of Statutory Accounting Principles No. 56
- SEC Regs Comm 06/09 is the June 2009 minutes of the CAQ SEC Regulations Committee

Pending content

The excerpts from the Codification reproduced in this Handbook include current content and pending content amended by the following ASUs that are not yet effective for all entities in their annual financial statements.

- ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments
- ASU 2023-02, Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method

Terminology

Throughout this Handbook, we use the term **enterprise** to describe the reporting entity that is evaluating a **legal entity** for consolidation. A **legal entity** can be a variable interest entity (VIE) or a voting interest entity (VOE).

November 2023 edition

This edition of our Handbook includes new and updated interpretations based on our experience with companies applying Topic 810. New Questions and Examples are identified with ** and items that have been significantly updated or revised are identified with #. The Index of changes identifies all significant changes.

Abbreviations

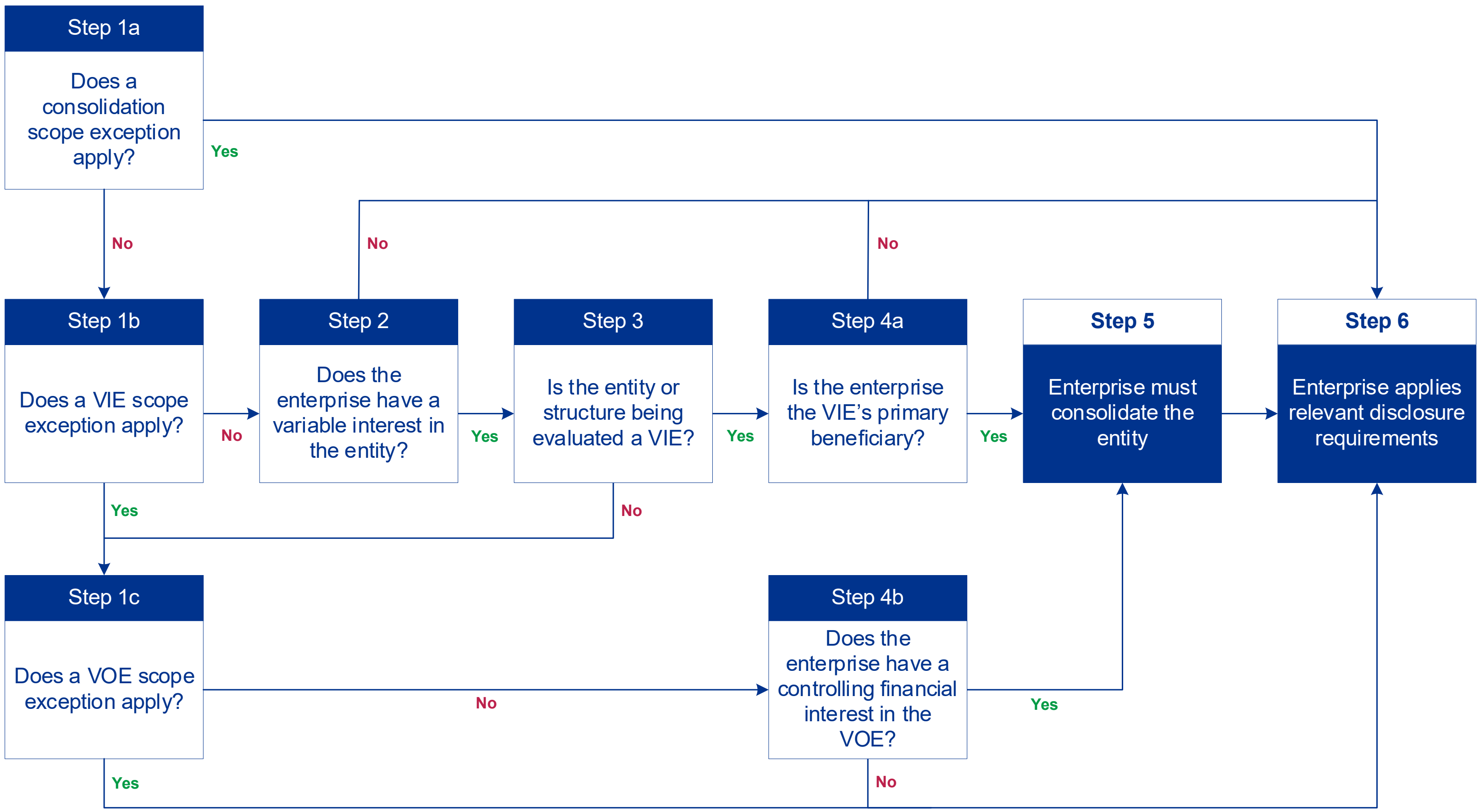
We use the following abbreviations in this Handbook:

1940 Act	Investment Company Act of 1940
AOCI	Accumulated other comprehensive income
APIC	Additional paid-in capital
BDC	Business development company
CFE	Collateralized financing entity
CTA	Cumulative translation adjustment
EBITDA	Earnings before interest, taxes, depreciation and amortization
EPS	Earnings per share
GP	General partner
ICFR	Internal control over financial reporting
IPR&D	In-process research and development
LP	Limited partner
MD&A	Management's discussion and analysis
NCI	Noncontrolling interest
NFP	Not-for-profit entity
OCI	Other comprehensive income
PBE	Public business entity
PP&E	Property, plant and equipment
REIT	Real estate investment trust
SPE	Special-purpose entity
TRS	Total return swap
VIE	Variable interest entity
VOE	Voting interest entity

1. Executive summary

Topic 810 contains two primary consolidation models: the VIE consolidation model and the VOE consolidation model. Determining which model applies is essential to properly apply Topic 810.

The process for determining which model to apply and the financial reporting implications can be summarized in six steps as shown in the following diagram.



Step 1: Scope exceptions

Topic 810 contains scope exceptions, with some applying to both models and others applying only to the VIE consolidation model or only to the VOE consolidation model.

The follow table summarizes the types of scope exceptions and identifies where to find more information in this Handbook.

Exception	Description and impact	Reference
Consolidation scope exceptions	Topic 810 does not apply to arrangements that do not involve a legal entity. Further, some legal entities are out of the scope of Topic 810. If either of these conditions exist, Topic 810 does not apply.	Section 2.3
VIE scope exceptions	Some legal entities are in the scope of Topic 810 but out of the scope of the VIE subsections – e.g. companies that apply the private company accounting alternatives for legal entities under common control. In this situation, only the VOE subsections, including their scope exceptions, apply.	Sections 2.4 and 2.6
VOE scope exceptions	The VOE scope exceptions are evaluated last. If a VIE scope exception applies – or if the legal entity is not a VIE (see Step 3) – an enterprise evaluates whether a VOE scope exception applies. If so, Topic 810 does not apply.	Section 2.5

Step 2: Is the interest a variable interest?

A variable interest is an interest through which an enterprise involved with a legal entity shares in that entity's economic risks and rewards. The interest absorbs some of the entity's expected losses, expected residual returns or both.

To identify whether it has a variable interest in a legal entity, an enterprise:

— identifies the risks created by the legal entity by applying the by-design approach;
— identifies the legal entity's explicit and implicit interests; and
— determines which interests absorb the risks.

Section 3.3 discusses the by-design approach and sections 3.4 and 3.5 discuss explicit and implicit variable interests and how to determine which ones absorb the risks identified.

Special consideration is necessary for some types of interests.

Concept	Description	Reference
Interest in specified assets	An interest in specified assets of a legal entity is not a variable interest in the legal entity itself and is generally excluded when applying the VIE consolidation model.	Section 3.6

Concept	Description	Reference
Silo VIE	A silo VIE exists only if its operations are segregated from the rest of a VIE. If a silo VIE is identified in a VIE, the VIE consolidation guidance is applied separately to the silo VIE and to the host VIE (i.e. the legal entity minus the silo VIE).	Section 3.7
Decision-maker fee	A decision-maker has the power to direct the activities that most significantly impact the legal entity's economic performance. A fee paid to a decision-maker may represent a variable interest in a legal entity.	Section 3.8

Expected losses and expected residual returns (i.e. expected variability) are relevant in identifying variable interest holders. Read more: Chapter 10

Step 3: Is the entity a VIE?

If a legal entity is in the scope of the VIE subsections of Subtopic 810-10 (Step 1) and the enterprise has a variable interest in that legal entity (Step 2), it evaluates whether the legal entity is a VIE.

The VIE analysis focuses on the amount and characteristics of a legal entity's equity. If a legal entity's equity has any one of the following characteristics then it is a VIE.

Characteristic	Description	Reference
First characteristic	The legal entity does not have sufficient equity at risk to finance its activities without additional subordinated financial support.	Section 4.3
Second characteristic	The equity-at-risk group lacks the power to direct the activities that most significantly impact the legal entity's economic performance.	Section 4.4
Third characteristic	The equity-at-risk group is not obligated to absorb the legal entity's expected losses.	Section 4.5
Fourth characteristic	The equity-at-risk group does not have the right to receive the legal entity's expected residual returns.	Section 4.6
Fifth characteristic	The individual equity investors' voting rights and economic interests in the legal entity are disproportionate, and substantially all of the legal entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights.	Section 4.7

An enterprise is not required to reconsider whether a VOE is a VIE, or vice versa, during each reporting period. Reconsideration is required only when certain events occur that may indicate the legal entity's design has changed. Read more: Section 4.8

Expected losses and expected residual returns (i.e. expected variability) are relevant in determining whether a legal entity is a VIE. Read more: Chapter 10

Step 4a: Which party (if any) is the primary beneficiary of a VIE?

The enterprise that holds a controlling financial interest in a VIE is the primary beneficiary and consolidates the VIE. A variable interest holder has a controlling financial interest in a VIE if it meets both of the primary beneficiary criteria.

Primary beneficiary criteria		
Power criterion	The variable interest holder has the power to direct the activities that most significantly impact the VIE's economic performance.	Section 6.2
Significant variable interest criterion	The variable interest holder has the obligation to absorb losses of the VIE, or the right to receive benefits from the VIE, that could potentially be significant to the VIE.	

Power criterion

Determining whether an enterprise meets the power criterion can be complex. However, there are two broad steps for determining if an enterprise meets this criterion.

Step 1	Identify the activities that most significantly impact a VIE's economic performance	Section 6.3.20
Step 2	Identify the party with the power to control the activities identified in Step 1	Section 6.3.30

When identifying the party that meets this criterion, kick-out rights and participating rights are considered only if a single enterprise has the unilateral ability to exercise those rights and the rights are substantive. Read more: Section 6.4

Only one party can meet the power criterion. If multiple parties have shared power to direct the most significant activities of a VIE or if the variable interest holders comprise a related party group, further evaluation is needed to determine which party, if any, meets the power criterion. Read more: Section 6.5

Significant variable interest criterion

To meet this criterion, an enterprise must have the obligation to absorb losses or right to receive benefits that could potentially be significant to a VIE. An enterprise considers both current and potential future circumstances when evaluating this criterion. Further, a quantitative approach should not be the sole determinant in evaluating this criterion. Read more: Section 6.6

Impact of related parties on the primary beneficiary analysis

One of the significant ways in which the VIE consolidation guidance differs from the VOE consolidation guidance is the role of related parties in the analysis. If parties related to the enterprise hold a variable interest in a VIE in which the enterprise also holds a variable interest, the enterprise is required to consider interests held by its related parties when applying the primary beneficiary criteria. This may cause the enterprise to reach a different conclusion than it otherwise would have if it considered only its own interest in the VIE. Read more: Sections 6.5.20, 6.5.30, 6.6.20

Primary beneficiary reconsideration

In contrast to the event-driven reconsideration of a legal entity's VIE or VOE status discussed in Step 3, an enterprise must continually reassess which party is a VIE's primary beneficiary. Read more: Section 6.7

Step 4b: Which party (if any) controls a VOE?

The enterprise that holds a controlling financial interest in a VOE consolidates the VOE. A controlling financial interest in a VOE is an equity interest held by a single enterprise that has the ability to control the decisions made in the ordinary course of the VOE's business.

There is a rebuttable presumption that control rests with the enterprise that has majority voting control (the 'majority holder'). The majority holder in the context of the VOE consolidation model is defined based on the type of entity.

Entity type	Majority holder definition	
Limited partnerships	Ownership by one LP, directly or indirectly, of > 50% of the limited partnership's kick-out rights through voting interests – majority kick-out right holder	Section 5.2
All other legal entities	Ownership by one reporting entity, directly or indirectly, of > 50% of the outstanding voting shares – majority shareholder	

However, noncontrolling rights may negate the power to control held by a majority holder if the NCI holder(s) has substantive participating rights or if the power to control has been conveyed to a single minority interest holder through an agreement with other equity holders. Read more: Section 5.3

Step 5: Consolidation

Consolidated financial statements represent the financial position and operating results of a single economic entity. Consolidation and deconsolidation procedures can be broken into three distinct phases – initial measurement, subsequent measurement and accounting for changes in ownership.

Initial measurement	A key determination is whether the subsidiary meets the definition of a business. If so, the parent initially measures the assets, liabilities and NCI using the acquisition method under Topic 805. If the subsidiary is not a business, the parent applies the asset acquisition guidance in Subtopic 805-50. In this case, different initial measurement guidance applies depending on whether the subsidiary is a VIE. Common control transactions are generally initially recognized based on the parent's carrying amounts.	Sections 7.2 and 7.3
Subsequent measurement	After initial measurement, the subsidiary's assets, liabilities and NCI are generally accounted for in the same manner regardless of whether the subsidiary is a VOE or VIE – i.e. intra-entity balances and transactions are fully eliminated. However, the attribution of certain intra-entity transactions between the parent and NCI differ depending on whether the subsidiary is a VIE. Attribution of the subsidiary's income or loss may also be affected when NCI is redeemable.	Sections 7.4, 7.5.10 and 7.5.20
Changes in ownership	A change in ownership that does not result in a change in control is accounted for as an equity transaction (unless other US GAAP applies). No gain or loss is recognized. When a parent loses control, it deconsolidates the subsidiary and a gain or loss generally results.	Sections 7.5.30 and 7.6

Step 6: Presentation and disclosure

A parent preparing consolidated financial statements combines each of its assets, liabilities and components of comprehensive income with those of the legal entities in which it has a controlling financial interest and then eliminates intra-entity transactions. The consolidated amounts are generally presented in their natural classifications, with some exceptions.

Amounts attributable to the NCI are generally presented on single lines in the income statement (under consolidated net income) and the balance sheet (in the equity section). However, redeemable NCI must be presented outside of permanent equity by entities that are subject to SEC reporting requirements. Read more: Section 8.2

A parent that prepares consolidated financial statements needs to consider the disclosure requirements of both Topic 805 and Subtopic 810-10. Read more: Section 8.3

Further, Subtopic 810-10 contains disclosure requirements for enterprises involved with VIEs – one set for primary beneficiaries and another set for all other variable interest holders. Read more: Section 8.3

Other matters

The following items are discussed in distinct sections of this publication.

CFEs	A CFE is an entity that holds financial assets (e.g. as asset-backed securities) and issues beneficial interests to investors. Because a CFE generally has little or no equity, it is typically a VIE and subject to the VIE consolidation model. A primary beneficiary may elect to measure certain CFEs' financial assets and financial liabilities using the measurement alternative. The measurement alternative allows the primary beneficiary to measure both the financial assets and the financial liabilities of the CFE based on the more observable of the fair value of the assets or the fair value of the liabilities. A primary beneficiary that elects this measurement alternative is required to provide disclosures specific to the CFE under Subtopic 810-10. It is also subject to the relevant disclosure guidance in Topic 820 (fair value measurement) and Topic 825 (financial instruments).	Sections 7.7 and 8.3.40
Entities controlled by contract	Originally written in the context of physician practice management entities, there is specific guidance for any legal entity that is controlled by contract, provided the legal entity is not a VIE. Instead of applying the definition of a controlling financial interest using the VOE consolidation model, this guidance has its own definition of a controlling financial interest in the context of a contractual relationship.	Section 9.2
Combined financial statements	Combined financial statements are typically presented for entities under common control (or under common management) when there is no controlling financial interest between the entities.	Section 9.3
NFP entities	Unless an enterprise is using an NFP to circumvent the VIE consolidation model, that model is not applied to NFP entities. Instead, Subtopic 958-810 generally applies to NFPs.	Section 9.4

2. Objective and scope

Detailed contents

Item significantly updated in this edition: #

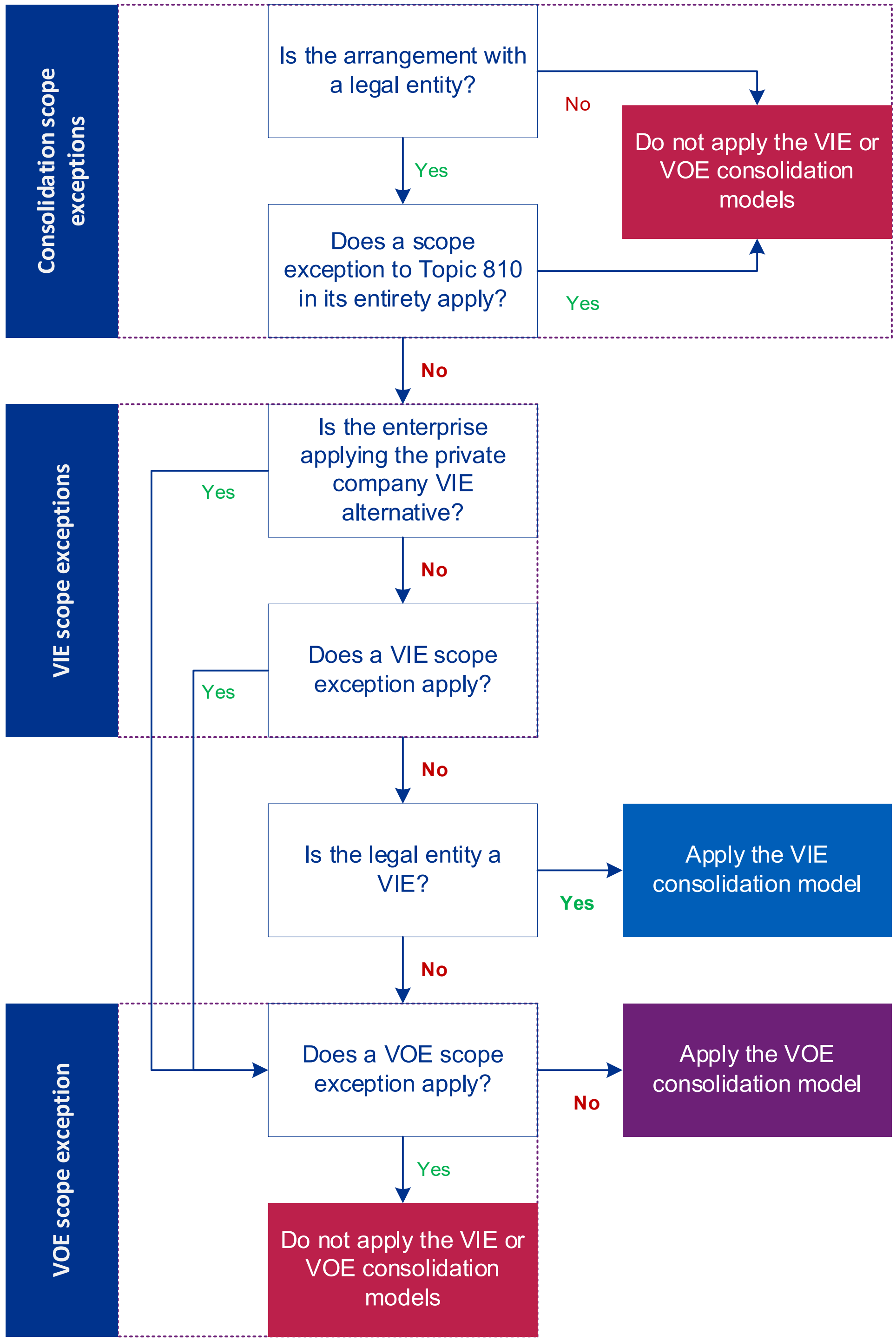
2.1 How the standard works

The objective of consolidated financial statements is to present the financial position of a parent and its subsidiaries as if the consolidated group were a single economic entity.

Topic 810 contains two primary consolidation models – the variable interest entity (VIE) consolidation model and the voting interest entity (VOE) consolidation model.

There are numerous scope exceptions, with some applying to both models and others applying only to the VIE consolidation model or only to the VOE consolidation model. Further, private companies can elect not to apply the VIE consolidation model to certain legal entities with which they are under common control.

The threshold scope issue is whether an arrangement in which an enterprise has a potential variable interest is a legal entity because Topic 810 can apply only if the underlying arrangement is a legal entity. The following decision tree summarizes the steps in determining whether any of the numerous scope exceptions applies.


Consolidation scope exceptions
Is the arrangement with a legal entity?
No
Do not apply the VIE or VOE consolidation models
Yes
Does a scope exception to Topic 810 in its entirety apply?
Yes
No
VIE scope exceptions
Is the enterprise applying the private company VIE alternative?
Yes
No
Does a VIE scope exception apply?
Yes
No
Is the legal entity a VIE?
Yes
Apply the VIE consolidation model
No
VOE scope exception
Does a VOE scope exception apply?
No
Apply the VOE consolidation model
Yes
Do not apply the VIE or VOE consolidation models

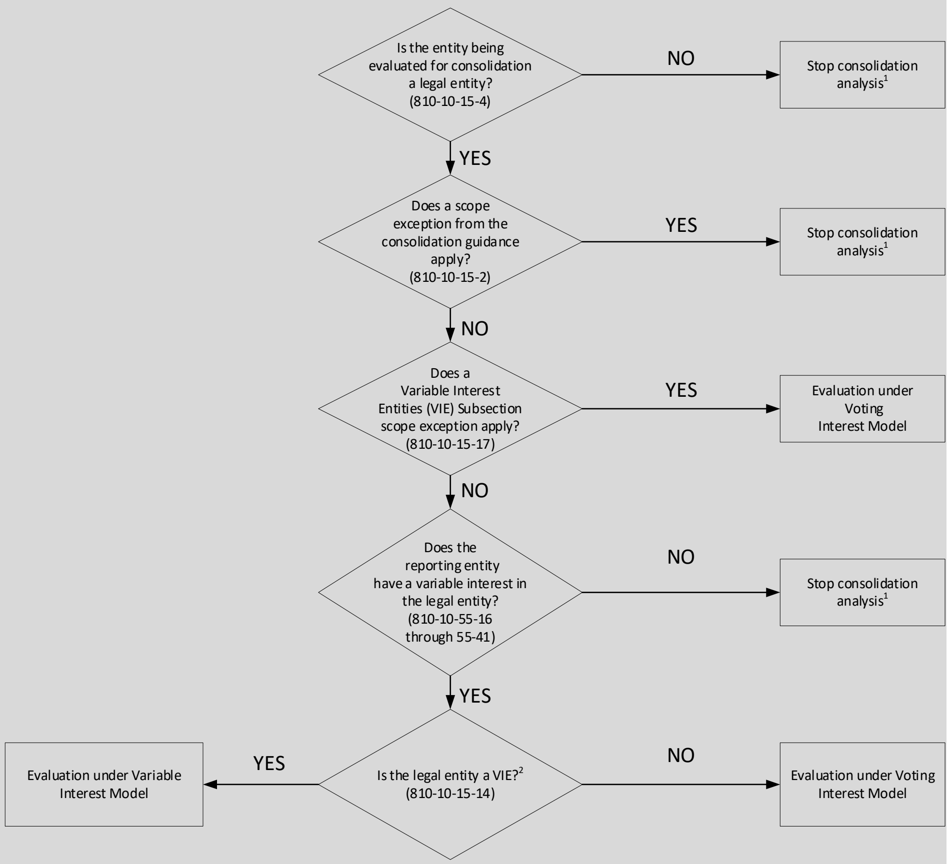
2.2 Objective of consolidation

Excerpt from ASC 810-10

General

05-6 The following flowchart provides an overview of the guidance in this Subtopic for evaluating whether a reporting entity should consolidate another legal entity. The flowchart does not include all of the guidance in this Subtopic and is not intended as a substitute for the guidance in this Subtopic. For example, the flowchart does not illustrate the consolidation analysis for entities controlled by contract.

Consolidation Analysis in Subtopic 810-10



[1] Consolidation not required; however, evaluation of the other generally accepted accounting principles (GAAP) may be relevant to determine recognition, measurement, or disclosure.

[2] A legal entity is a VIE if any of the following conditions exist:

a. The equity investment at risk is not sufficient to finance the activities of the entity without additional subordinated financial support provided by any parties.

b. As a group, the holders of the equity investment at risk lack any of the following characteristics of a controlling financial interest:

1. The power to direct the activities 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 (such as those of a common shareholder in a corporation).
   ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists
      .01 A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive kick-out rights through voting interests over the general partner(s).
      .02 Limited partners with equity at risk are able to exercise substantive participating rights over the general partner(s).
2. The obligation to absorb expected losses.
3. The right to receive expected residual returns.

c. The equity investors; voting rights are not proportional to the economics, and substantially all of the entity either involve or are conducted on behalf of an investor that has disproportionately few voting rights.

10-1 The purpose of **consolidated financial statements** is to present, primarily for the benefit of the **owners** and creditors of the **parent**, the results of operations and the financial position of a parent and all its **subsidiaries** as if the **consolidated group** were a single economic entity. There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities.

An enterprise determines whether to apply the VOE or VIE consolidation model to a legal entity based on the characteristics of the entity's equity and governance.

The FASB developed the VIE consolidation model to augment the VOE consolidation model primarily because of concerns about consolidation practices by enterprises involved with special-purpose entities. The objective of the VIE consolidation model is to provide consolidation guidance for situations in which voting interests do not adequately reflect the controlling interests in a legal entity. For example, this occurs when equity investors lack the characteristics of a controlling financial interest or lack sufficient equity at risk for the entity to operate without additional subordinated financial support from other parties.

Question 2.2.10

How does the VIE consolidation model achieve the objective of consolidation when voting interests do not adequately reflect a legal entity's controlling interests?

Interpretive response: To achieve its objective, the FASB identified characteristics that indicate voting interests may not be effective in identifying whether a legal entity should be consolidated by another enterprise and, if so, which enterprise.

The characteristics focus on evaluating how the economic risks and rewards inherent in a legal entity's assets and liabilities are shared among the variable interest holders and who has the authority to make the decisions that most significantly impact those risks and rewards.

It is important to understand how these, and other terms are defined in the VIE Subsections of Subtopic 810-10.

Term	Definition
Economic risks and rewards	A legal entity's expected losses and expected residual returns
Variable interest	The mechanism or interest through which an enterprise shares in a legal entity's economic risks and rewards
Primary beneficiary	The enterprise that is required to consolidate the legal entity through a variable interest (which may not necessarily be an equity interest)

The above definition of a variable interest is the plain-English definition. The 'technical' definition in Subtopic 810-10 defines variable interests as "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." [810-10 Glossary]

Variable interests include the following (not exhaustive):

— A legal entity's voting stock;
— loans to an entity;
— guarantees that an entity will repay its obligations; and
— rights to purchase a majority of an entity's assets at a strike price other than fair value (see chapter 3).

An enterprise that does not have a variable interest in a legal entity cannot consolidate the entity.

2.3 Consolidation scope exceptions

2.3.10 Overview

As a first step, Topic 810 applies only to legal entities – i.e. there is a 'legal entity filter' (see section 2.3.20).

After an enterprise concludes that its arrangement is with a legal entity, it evaluates whether a scope exception applies. Topic 810 contains scope exceptions that apply to the entire topic ('consolidation scope exceptions'), as well as exceptions that apply to either the VIE consolidation model or the VOE consolidation model.

Some of the consolidation scope exceptions exempt an enterprise or arrangement from all of Topic 810's provisions under both the VIE and VOE consolidation models (see section 2.3.30). Others exempt an enterprise or arrangement from only some of the Topic's provisions (see sections 2.4, 2.5 and 2.6).

2.3.20 Legal entities for consolidation purposes

Excerpt from ASC 810-10

General

> Entities

15-4 All **legal entities** are subject to this Topic's evaluation guidance for consolidation by a reporting entity, with specific qualifications and exceptions noted below.

15-5 Paragraph not used.

15-6 The guidance in this Topic applies to all reporting entities, with specific qualifications and exceptions noted below.

20 Glossary

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

Topic 810 does not apply to arrangements involving another party that doesn't meet the definition of a legal entity. This filter is based solely on whether an arrangement is with a legal entity; it is not limited to specific industries or to the nature of the activities or assets held or used in the arrangement. [810-10-15-4]

Question 2.3.10
What are the attributes of a legal entity for consolidation purposes?

Interpretive response: We believe the following are attributes of a legal entity for consolidation purposes:

- possessing a unique tax identification or filing a separate tax return in any jurisdiction;
- issuing separate financial statements or complying with other regulatory filing requirements;
- entering into contracts or billing arrangements in its own name;
- possessing legal standing in its jurisdiction;
- possessing the ability to obtain financing or open a bank account.

None of these attributes is determinative. The evaluation of whether an arrangement is with a legal entity should be based on all the relevant facts and circumstances and may require the assistance of legal counsel.

The FASB's basis for treating individual registered mutual funds as legal entities is discussed in Question 2.3.70.

Question 2.3.20

What are examples of legal entities for consolidation purposes?

Interpretive response: Examples of entities that meet Topic 810's legal entity filter includes, but are not limited to, corporations, limited partnerships, general partnerships, limited liability limited partnerships, limited liability companies, trusts and individual series mutual funds required to comply with the 1940 Act.

Arrangements that might be considered to involve legal entities for consolidation purposes include the following (not exhaustive):

- joint ventures
- product and inventory financing arrangements
- vendor financing arrangements
- research and development ventures
- collaborative arrangements
- outsourcing arrangements
- leasing arrangements
  - operating leases with purchase options, residual value guarantees, fixed-price renewal options, or similar features
  - direct financing leases
  - build-to-suit arrangements
  - synthetic leases
  - leveraged leases
  - sale-leasebacks
- franchise arrangements
- insurance and reinsurance arrangements
- residential and commercial construction arrangements
  - lot option arrangements
- energy arrangements
  - capacity purchase agreements
  - wind or solar farms
  - synthetic fuel partnerships
- securitization and similar arrangements
  - residential mortgage securitizations
  - commercial mortgage securitizations
  - credit card securitizations
  - collateralized debt obligations
  - collateralized loan obligations
  - collateralized bond obligations
  - commercial paper conduits
  - Enhanced Equipment Trust Certificates
  - trust preferred securities
- investment arrangements
  - mutual funds
  - hedge funds
  - venture capital funds
  - private equity funds
  - real estate funds, including affordable housing partnerships.

Question 2.3.30

Are fiduciary accounts considered legal entities for consolidation purposes?

Interpretive response: No. Consolidation applies only to legal entities (as defined in Subtopic 810-10). If assets are held on behalf of others but not in a separate legal entity, the consolidation models do not apply to the fiduciary accounts.

Question 2.3.40

Are collaborative arrangements not conducted through separate legal entities considered legal entities for consolidation purposes?

Interpretive response: Generally, no. The consolidation models generally apply only to legal entities. Therefore, they do not apply to a collaborative arrangement conducted outside of a separate legal entity.

For example, two pharmaceutical companies enter into a joint development agreement for a drug candidate. Under the agreement, each company conducts R&D and shares the total costs on a 50/50 basis. Each quarter, the companies provide each other with financial information about their respective activities (and costs) and one company provides a payment to the other as necessary under the agreement.

This joint development agreement is not conducted through a separate legal entity and therefore the consolidation models do not apply. Instead, the companies consider the guidance for collaborative arrangements in Topic 808 and Topic 606 (if applicable). For additional discussion, see section 2.2.20 in KPMG Handbook, Revenue recognition.

However, if the companies had formed a separate legal entity to conduct the activities, they would need to evaluate whether the legal entity must be consolidated.

Question 2.3.50

Are undivided interests considered legal entities for consolidation purposes?

Interpretive response: No. If an enterprise owns an undivided interest in each of a legal entity's assets and is proportionately liable for its share of each of the liabilities, it generally accounts for its investment in the legal entity under the equity method of accounting (see Question 3.6.20). [323-10-15-3 – 15-11, 323-30-15-1 – 15-4, 970-323-25-12]

However, there are limited exceptions if: [810-10-45-14, 910-810-45-1, 930-810-45-1, 932-810-45-1, 970-810-45-1]

— the investor and the legal entity operate in the construction or extractive industries; or
— the interest is in real property if certain conditions are met.

In these situations, the enterprise applies the recognition and measurement principles in Topic 323 (equity method) but may present its proportionate share of the legal entity's individual assets, liabilities and operations. See section 2.3.50 in KPMG Handbook, Equity method of accounting, for additional discussion.

Question 2.3.60

Are portions of legal entities or virtual entities considered legal entities for consolidation purposes?

Interpretive response: Generally, no. So-called virtual entities or portions of entities are not subject to the consolidation models unless they are silo VIEs.

A silo VIE exists if: [810-10-25-57 – 25-58]

— a portion of a VIE's assets, related liabilities and other interests (such as guarantees and purchase options) are economically segregated – i.e. a potential silo exists; and

— the residual entity (i.e. the entire legal entity minus interests in specified assets) is a VIE.

Section 3.7 discusses how to evaluate whether portions of a legal entity have been economically segregated from each other and whether a silo VIE exists.

Question 2.3.70

Are individual registered series mutual funds considered legal entities for consolidation purposes?

Background: A registered series mutual fund is a type of mutual fund typically organized as a virtual entity within an umbrella legal entity (often organized as a Delaware master trust). A registered series mutual fund is required to comply with the 1940 Act for registered mutual funds.

The umbrella legal entity typically has multiple series mutual funds within it and a single board of trustees. The investment interests of each series mutual fund participate in the risks and returns of the individual series but none of the other series within the umbrella trust. Consequently, each series mutual fund is isolated economically from all of the other series mutual funds within the umbrella trust.

Interpretive response: Yes. The FASB decided that it was reasonable to consider an individual registered series mutual fund to be a separate legal entity because each individual series fund: [ASU 2015-02.BC38–BC39]

— has its own investment objectives and policies;
— has its own custodial agreement;
— has its own shareholders separate from other series funds;
— has a unique tax identification;
— files separate tax returns with the IRS;
— has separate audited financial statements; and
— is considered a separate investment company in virtually all circumstances for purposes of investor protection afforded by the 1940 Act.

Subtopic 810-10 also addresses the activities that most significantly impact the economic performance of a series mutual fund (see Question 4.4.90).

Question 2.3.80

Are structures that are economically similar to a registered series mutual fund considered legal entities for consolidation purposes?

Background: There are other structures that are designed to function in a manner similar to registered series mutual funds as described in Question 2.3.70. These structures, which may be organized in the United States, are often domiciled outside of the United States. They include but are not limited to international series trusts and segregated or protected cell companies. In general, these structures are designed to economically isolate groups of assets, liabilities and related equity interests for investment or other purposes within an umbrella legal entity.

Interpretive response: It depends. If a legal structure has the applicable characteristics described in see Question 2.3.70, we believe it is considered a legal entity for consolidation purposes.

Further, we understand the SEC staff believes that the existence of the following characteristics in these nonregistered structures may indicate that the individual funds are separate legal entities:

— the funds are economically isolated from the rest of the umbrella entity; and
— the funds' investors have the power to direct the activities that most significantly impact the funds' economic performance.

2.3.30 Specific consolidation scope exceptions

Excerpt from ASC 810-10

General

> Entities

15-12 The guidance in this Topic does not apply in any of the following circumstances:

a. An employer shall not consolidate an employee benefit plan subject to the provisions of Topic 712 or 715.
b. Subparagraph superseded by Accounting Standards Update No. 2009-16
c. Subparagraph superseded by Accounting Standards Update No. 2009-16
d. Except as discussed in paragraph 946-810-45-3, an investment company within the scope of Topic 946 shall not consolidate an investee that is not an investment company.
e. A reporting entity shall not consolidate a governmental organization and shall not consolidate a financing entity established by a governmental organization unless the financing entity meets both of the following conditions:
   1. Is not a governmental organization
   2. Is used by the business entity in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entities Subsections.
f. A reporting entity shall not consolidate a legal entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.
   1. A legal entity that is not required to comply with Rule 2a-7 of the Investment Company Act of 1940 qualifies for this exception if it is similar in its purpose and design, including the risks that the legal entity was designed to create and pass through to its investors, as compared with a legal entity required to comply with Rule 2a-7.
   2. A reporting entity subject to this scope exception shall disclose any explicit arrangements to provide financial support to legal entities that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7, as well as any instances of such support provided for the periods presented in the performance statement. For purposes of applying this disclosure requirement, the types of support that should be considered include, but are not limited to, any of the following:
      i. Capital contributions (except pari passu investments)
      ii. Standby letters of credit
      iii Guarantees of principal and interest on debt investments held by the legal entity
      iv. Agreements to purchase financial assets for amounts greater than fair value (for instance, at amortized cost or par value when the financial assets experience significant credit deterioration)
      v. Waivers of fees, including management fees.

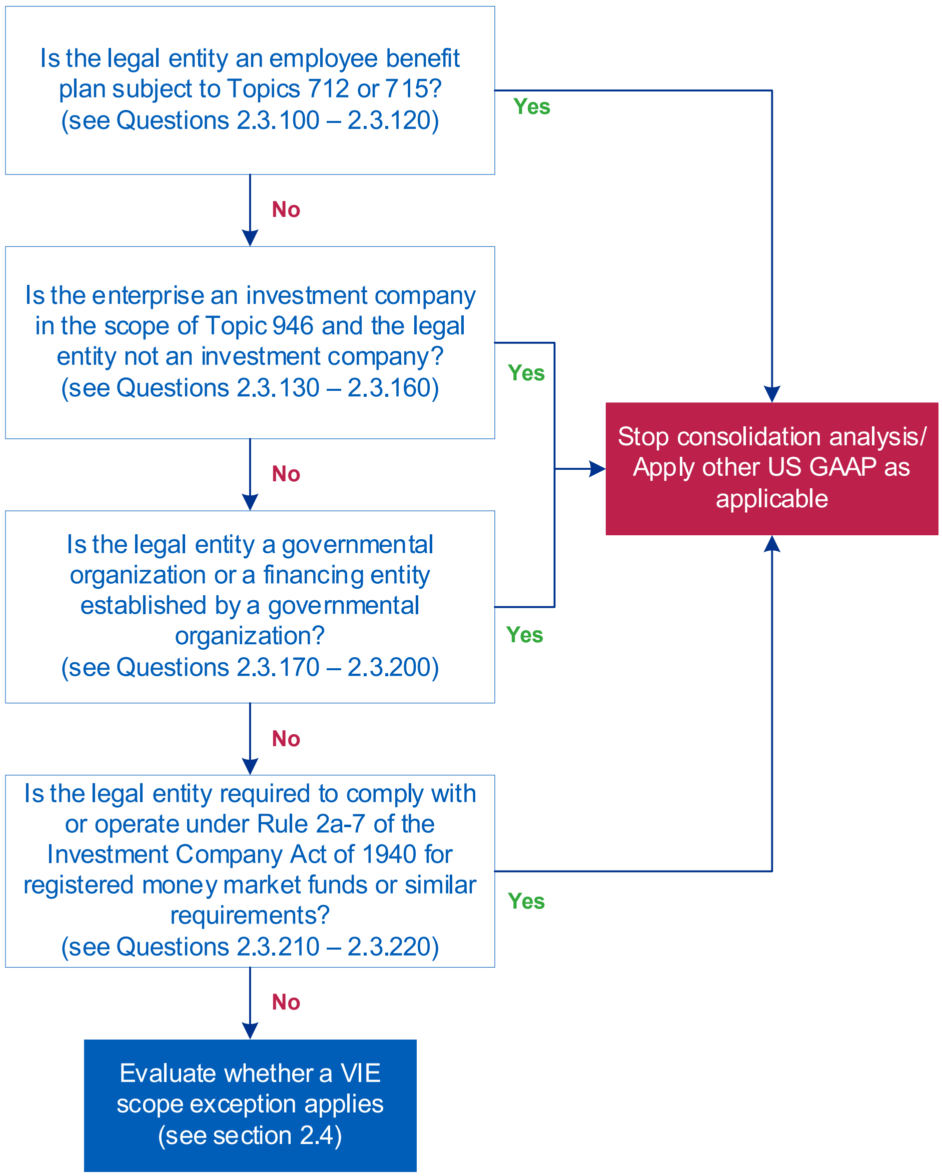
Once an enterprise determines that an arrangement is a legal entity, it then determines if one of the specific consolidation scope exceptions applies to exempt it from applying Topic 810.

An enterprise should carefully evaluate these exceptions because they might not exempt it from the consolidation provisions of Subtopic 810-10 under all circumstances.

Question 2.3.90

What are the specific consolidation scope exceptions?

Interpretive response: Having determined that the arrangement is a legal entity (see section 2.3.20), the following decision tree summarizes the scope exceptions from the consolidation guidance.



Question 2.3.100

What types of employee benefit plans does Topic 810 exempt from being consolidated by their sponsoring employer?

Interpretive response: An employer is exempt from consolidating employee benefit plans that are accounted for under: [810-10-15-12(a)]

— Topic 712 (nonretirement postemployment benefit plans);
— Subtopic 715-30 (defined benefit pension plans); or
— Subtopic 715-60 (other postretirement defined benefit plans).

Further, we believe employee benefit plans that apply Topic 960 (defined benefit pension plans) are exempt from applying the consolidation guidance in Topic 810 to their investments in legal entities.

The scope exception applies only to the sponsoring employer. Other parties that have a variable interest in an employee benefit plan must still consider the guidance in Topic 810. Those parties may include trustees, advisors and plan administrators.

Question 2.3.110

Are defined contribution plans and trusts used in funding health and welfare benefit plans exempt from being consolidated?

Background: Health and welfare benefit plans may segregate and legally restrict assets intended to pay all or part of the covered benefits by establishing an irrevocable, bankruptcy-remote Voluntary Employees' Beneficiary Association (VEBA or 501(c)(9) trust). Employers often contribute cash to a VEBA trust to cover the short-term lag in their incurred but not reported claims. Contributions made to these trusts are generally tax deductible for the sponsoring employer at the date of funding. The AICPA requires employers to account for those trusts in the context of the related plan based on the underlying measurement concepts of Subtopics 715-60 and 712-10. [AAG-EBP.7]

Interpretive response: Yes. The scope exception for employee benefit plans refers to plans accounted for under Topics 712 and 715. However, the FASB intended this scope exception to also apply to employers' accounting for defined contribution plans and trusts used in funding health and welfare benefit plans that apply Topics 962 and 965, respectively.

We believe it may also be appropriate to apply the employee benefit plan scope exception by analogy to employee benefit plan entities other than those described above, such as employee stock ownership plans that are accounted for under Topic 718 (stock compensation). See Question 12.5.30 in KPMG Handbook, Employee benefits, for further details.

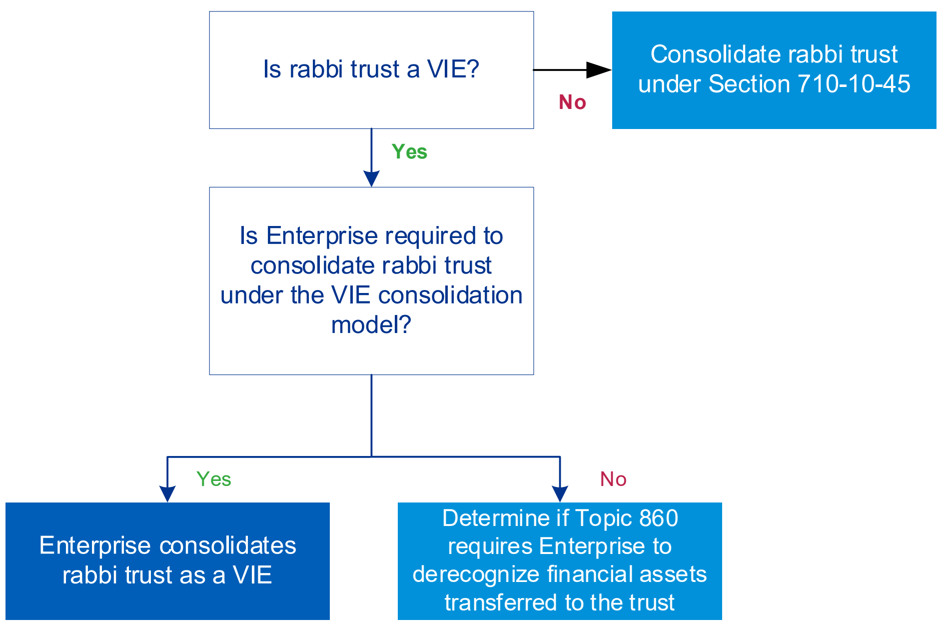
Question 2.3.120
Are rabbi trusts exempt from being consolidated?

Interpretive response: No. A rabbi trust is not an employee benefit plan and it does not qualify for any of the other VIE scope exceptions (see section 2.4).

A rabbi trust is a legal entity generally used to protect funded deferred employee compensation benefits from loss resulting from certain events other than bankruptcy of the employer (reporting enterprise).

A rabbi trust generally has no equity and typically has a liability to the employees to whom the deferred compensation benefits are owed. As a result, a rabbi trust generally will be a VIE. Even if a rabbi trust does have equity, it generally will be a VIE because the equity investment is not at risk (see section 4.3.30), and the employer provided the equity investment to the employee.

The employer (reporting enterprise) evaluates a rabbi trust as follows depending on whether the rabbi trust is a VIE. [710-10-25-15 – 25-18, 45-1]



We believe the employer is often the primary beneficiary of a rabbi trust that is a VIE because:

— its exposure to the trust's variability represents a variable interest (see chapter 3); and

— it has the power to make funding and investment strategy decisions, which are typically the decisions that most significantly impact the trust's economic performance (see chapter 6).

Question 2.3.130
How is the investment companies scope exception applied?

Background: Unlike the other specific consolidation exceptions discussed in this section, the exception for investment companies first considers the nature of the enterprise, then considers the nature of the legal entity.

The investment company scope exception was included by the FASB primarily to ensure that there was no conflict between the consolidation requirements of Subtopic 810-10 and SEC financial reporting regulations (principally the 1940 Act).

Interpretive response: An investment company in the scope of Topic 946 is exempt from consolidating an investee that is not an investment company. [810-10-15-12(d)]

However, the scope exception does not exempt an investment company from applying the VIE and VOE consolidation models to an operating entity that provides services to the investment company (e.g. investment adviser, transfer agent). The purpose of this type of investment is to provide services to the investment company, not to realize a gain on the sale of the investment. If an investment company holds a controlling financial interest in such an investee, the investment company should consolidate that investee instead of measuring the investment at fair value. [946-10-55-5, 946-810-45-3]

Similarly, investment companies themselves are subject to consolidation under the VIE and VOE consolidation models. As a result, an enterprise with a variable interest in an investment company evaluates the investment company for consolidation. Question 2.3.140 provides guidance on how to evaluate whether an investment company that is subject to SEC reporting requirements should consolidate another investment company and Question 2.3.150 provides guidance on whether that same guidance applies to non-registered investment companies.

Question 2.3.140#
What views has the SEC staff expressed regarding the investment companies scope exception?

Excerpt from IM Guidance Update 2014-11

RICs that are Feeder Funds or Funds of Funds

The staff has observed that a RIC that is a feeder fund in a master-feeder structure, or a RIC that is a fund of funds in the same group of investment companies, may have "a controlling financial interest in another entity" for purposes of Regulation S-X. In a master-feeder arrangement, the securities issued by the master fund are the only investment securities held by the RIC feeder fund[1] and may constitute a controlling financial interest in the master fund. A RIC that is a fund of funds may have a controlling financial interest in one or more of the underlying funds in the same group of investment companies as the fund of funds.

In the circumstances of a feeder fund, generally, the staff has taken the position that the financial presentation that is most meaningful is unconsolidated,[2] provided that, among other things: (i) the feeder fund attaches the financial statements of the master fund to its financial statements;[3] (ii) if the master fund is organized as a partnership,[4] the feeder fund separately discloses on its statement of operations the net investment income, the net realized gain or loss, and the net change in unrealized gain or loss allocated from the master fund;[5] and (iii) if the master fund is organized as a partnership,[6] the feeder fund includes the net investment income and expenses allocated from the master fund in its net investment income and expense ratios in its financial highlights.[7] In the staff's view, because a feeder fund typically is one of several investors in the master fund, such disclosure provides a meaningful and appropriately transparent presentation of the financial position and results of operations of the feeder fund.

In the circumstances of a fund of funds, generally, the staff has taken the position that the financial presentation that is most meaningful also is unconsolidated. A fund of funds typically invests in multiple underlying funds, may hold controlling financial interests in some underlying funds and non-controlling interests in other underlying funds, and the level of its interest in any particular underlying fund might fluctuate between controlling and non-controlling. In such circumstances, in the staff's view, if the fund of funds were to consolidate the financial statements of certain of its underlying funds for certain periods, the resulting financial presentation may not be meaningful and may be confusing to the fund of funds' investors. The staff notes, a fund of funds also should consider whether its investment in a single underlying fund is so significant to the fund of funds that its presentation of financial statements should be made in a manner similar to a master-feeder fund.[8]

BDCs with Wholly Owned Subsidiaries[9]

In reviewing registration statements and financial statements, the staff has observed[10] a number of BDCs that have wholly owned subsidiaries, for example, in order to facilitate investment in a portfolio company. Certain of these BDCs do not consolidate such subsidiaries, even though the design and purpose of the subsidiary (*e.g.*, a holding company) may be to act as an extension of the BDC's investment operations and to facilitate the execution of the BDC's investment strategy. As part of the registration statement and financial statement review process, the staff has generally suggested BDCs consolidate such subsidiaries, because the staff believes that consolidation provides investors with the most meaningful financial presentation in those statements.[11]

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1 *See* section 12(d)(1)(E) of the 1940 Act (providing an exemption from the limitations in section 12(d)(1) on, among other things, a RIC investing more than 5% of its total assets in securities issued by another investment company, provided that, among other requirements, such securities are the only investment securities held by the RIC).

2 However, if the design and purpose of the master-feeder structure is for the master fund to be wholly owned by a sole feeder fund, the staff encourages registrants to consult with the staff on whether consolidated financial presentation would be the most meaningful.

3 *See also* SEC Staff Generic Comment Letter for Investment Company CFOs (Dec. 30, 1998), available at http://www.sec.gov/divisions/investment/imlr1230.htm (indicating that: (1) a feeder fund's shareholder report contains two sets of financial statements, one for the master fund and another for the feeder fund; and (2) in instances where the feeder fund and the master fund have different fiscal year-ends, the staff would not object if, at each feeder fund's year-end, the audited shareholder report of the feeder fund is accompanied by the latest audited shareholder report of the master fund and by an unaudited balance sheet of the master fund and schedule of investments of the master fund as of the date of the feeder fund's financial statements).

4 It is the staff's position that if the master fund is organized as a corporation, classification of the master fund's income in the feeder fund's financial statements depends upon the distribution policies of the master fund. Until it is distributed, income received by the master fund is recorded by a feeder fund as unrealized appreciation. See SEC Staff Generic Comment Letter for Investment Company CFOs (Nov. 2, 1995), *available at* http://www.sec.gov/divisions/investment/ noaction/1995/accountingcomment110295.pdf.

5 *See generally* FASB ASC paragraphs 946-225-45-11 and 946-225-45-12. In accordance with FASB ASC paragraph 946-225-45-11, a feeder fund should separately disclose its allocated interest, dividends, and expenses when disclosing on its statement of operations its net investment income allocated from the master fund.

6 See *supra* note 4.

7 *See generally* FASB ASC paragraph 946-205-50-28.

8 *See generally* FASB ASC paragraph 946-210-45-7, and SEC Staff Generic Comment Letter for Investment Company CFOs (Nov. 7, 1997), *available at* http://www.sec.gov/divisions/investment/noaction/1997/cfo110797.pdf. The staff notes that this consideration should be made regardless of whether the fund of funds has a controlling financial interest or a non-controlling interest in the underlying fund.

9 Rule 1-02(aa) of Regulation S-X defines a wholly owned subsidiary as a subsidiary substantially all of whose outstanding voting shares are owned by its parent and/or the parent's other wholly owned subsidiaries.

10 The staff has also observed that some BDCs do not include in their financial statements disclosures required by FASB ASC paragraph 850-10-50-1 about certain transactions with investees that meet the definition of related parties in FASB ASC paragraph 850-10-20 (*e.g.*, certain directly or indirectly held portfolio companies, including holding companies). BDCs are reminded of their obligations to comply with FASB ASC Topic 850, *Related Party Disclosures*, because disclosures about related party transactions are important for shareholders to understand the financial statements and make informed investment decisions.

11 In the staff's view, RICs in similar circumstances also should consolidate wholly owned subsidiaries (*e.g.*, a RIC that uses a wholly owned subsidiary as a 'blocker').

Interpretive response: The staff of the SEC's Division of Investment Management issued IM Guidance Update 2014-11, which provides the views of the Division's Chief Accountant's Office about the presentation of consolidated financial statements for:

— certain investment companies ('RICs') registered under the 1940 Act; and
— investment companies that have elected to be treated as BDCs under the 1940 Act that have wholly owned subsidiaries.

The guidance highlights the importance of considering what financial presentation is most meaningful in the investment company's circumstances – i.e. what presentation most clearly communicates the financial position and operating results of the registrant. The SEC staff reiterated that consolidated financial statements are presumed to be the most meaningful when an enterprise has a controlling financial interest in an entity. However, the SEC staff guidance also discusses scenarios in which this presumption is overcome. [S-X Rule 3A-02, 810-10-10-1]

The SEC staff specifically addressed the following circumstances in its guidance. [SEC IM Guidance 2014-11]

RICs that are feeder funds

The SEC staff generally believes that unconsolidated financial statement presentation is most meaningful for a feeder fund if it provides appropriately transparent presentation and disclosure of its financial position and results of operations, and its relationship with the master fund.

This guidance is premised on the idea that a feeder fund is typically one of several investors in a master fund. However, if the structure is designed such that the master fund is wholly owned by a sole feeder fund, consolidated financial statements may be more appropriate and consultation with the staff is encouraged.

The staff expects the feeder fund to provide the following information.

Master fund financial statements	The feeder fund attaches the financial statements of the master fund to its financial statements.
Amounts allocated from the master fund – feeder fund's statement of operations	If the master fund is organized as a partnership, the feeder fund separately discloses in its statement of operations the net investment income, the net realized gain or loss, and the net change in unrealized gain or loss allocated from the master fund. [946-220-45-11 – 45-12] If the master fund is organized as a corporation, the SEC staff believes the classification of the master fund's income in the feeder fund's financial statements depends on the distribution policies of the master fund. Income received by the master fund is recorded by a feeder fund as unrealized appreciation until it is distributed.
Amounts allocated from the master fund – feeder fund's financial highlights	If the master fund is organized as a partnership, the feeder fund includes the net investment income and expenses allocated from the master fund in its net investment income and expense ratios in its financial highlights disclosure. [946-205-50-28] If the master fund is organized as a corporation, the SEC staff believes the classification (and therefore the impact on the net income and expense ratios) of the master fund's income in the feeder fund's financial statements depends on the distribution policies of the master fund. Income received by the master fund is recorded by a feeder fund as unrealized appreciation until it is distributed.

RICs that are fund of funds

The SEC staff generally believes that unconsolidated financial statement presentation is most meaningful. A fund of funds typically invests in multiple underlying funds. The significance of its interests (i.e. controlling versus noncontrolling) differs among underlying funds, and an interest in a given underlying fund may fluctuate over time. As a result, consolidating underlying funds could result in financial statements that are confusing to investors.

However, the SEC staff notes that a fund of funds should also consider whether its investment in a single underlying fund is so significant to the fund of funds that its presentation of financial statements should be made in a manner similar to a master-feeder fund. [946-210-45-7]

BDCs with wholly owned subsidiaries

The SEC staff generally suggests that BDCs consolidate wholly owned subsidiaries when the design and purpose of the subsidiaries (e.g. holding companies) may be to act as an extension of the BDC's investment operations and facilitate the execution of the BDC's investment strategy (see Question 2.3.160). Regulation S-X defines a wholly owned subsidiary as a subsidiary substantially all of whose outstanding voting shares are owned by its parent and/or the parent's other wholly owned subsidiaries. BDCs are also reminded to comply with related party disclosures in the context of wholly owned subsidiaries. RIC's in similar circumstances also should consolidate wholly owned subsidiaries. [S-X Rule 1-02(aa), 850-10-50-1]

For guidance on the consolidation for non-registered investment companies, see Question 2.3.150.

Question 2.3.150

Does a non-registered investment company always consolidate another investment company in which it has a controlling financial interest?

Interpretive response: No. Topic 810 does not exempt an investment company from applying its guidance to an investment in another investment company. However, non-registered investment companies (similar to registered investment companies and BDCs that follow the SEC staff's guidance, see Question 2.3.140) have established a long-standing industry practice of generally reporting their controlling and noncontrolling interests in other investment companies at fair value.

This practice has developed over time for the same reason that the SEC staff believes that unconsolidated presentation is generally more appropriate for a fund of funds – i.e. such presentation is more meaningful to investors (see Question 2.3.140). An investment company that holds controlling and noncontrolling interests in other investment companies manages those investments for the same purpose – i.e. to invest funds for returns from capital appreciation, investment income or both. [AAG-INV.7.11, SEC IM update 2014-11]

The FASB also acknowledged this practice in the basis for conclusions to ASU 2013-08, which redefined 'investment company' in US GAAP. The FASB proposed to require an investment company to consolidate controlling financial interests in a fund-of-funds structure, but ultimately decided not to finalize the proposed change. The Board cited stakeholders' concerns that: [ASU 2013-08.BC64]

> …consolidation would decrease the usefulness of investment company financial statements by giving prominence to controlled investees regardless of their significance to the investment company's net assets and would result in mixed presentation of similar investments in which some investments would be measured at fair value and other investments would be consolidated.

There are some situations in which a non-registered investment company may consolidate another investment company – i.e. when the investee fund is an extension of the investor fund's investment operations and is used to facilitate the execution of the investment strategy (see Question 2.3.160). In that case, the investee is consolidated if the investor has a controlling financial interest. This approach is consistent with the approach that the SEC staff uses in evaluating whether a BDC should consolidate an interest in a wholly owned subsidiary (see Question 2.3.140).

Although a non-registered investment company generally reports its interest in another investment company at fair value, it should consider whether the investment is so significant to the fund that presentation of financial statements in a manner similar to a master-feeder fund is more appropriate. [946-210-45-7, TQA 2220.18]

Question 2.3.160

When is an investee fund an extension of an investor fund?

Interpretive response: Determining whether an investee fund is operating as an extension of an investor fund requires careful consideration of the specific facts and circumstances, including but not limited to:

- business purpose and activities of the investee fund – i.e. whether the investee fund is in the scope of Topic 946;
- management of the investee fund;
- relationship to the investee fund;
- degree of ownership by the investor fund;
- whether there are unaffiliated investors in the investee fund; and
- investor fund's exit strategy with respect to the investee fund.

Questions 2.3.140 and 2.3.150 discuss whether an investor fund should consolidate an investee fund under Topic 810.

Question 2.3.130 discusses whether an investment company should consolidate an operating entity that provides services to the investment company.

Question 2.3.170

How is a governmental organization defined?

Background: The governmental organization scope exception exempts enterprises from applying Topic 810 to governmental organizations and financing entities (e.g. tax-exempt bond financing trusts) established by governmental organizations.

Interpretive response: A governmental organization is defined by the AICPA as having one or more of the following characteristics: [AAG-SLG.1.01]

- popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;
- the potential for unilateral dissolution by a government with the net assets reverting to a government; or
- the power to enact and enforce a tax levy.

There is a presumption that an entity is a governmental organization if it has the ability to issue directly (instead of through a state or municipal authority) interest-bearing debt that is exempt from federal taxation. However, this presumption may be overcome if there is compelling, relevant evidence that the entity does not have any other characteristics of a governmental organization.

Question 2.3.180

How is the governmental organization scope exception applied?

Interpretive response: The governmental organization scope exception exempts enterprises from applying Topic 810 to governmental organizations (see Question 2.3.170) and financing entities (e.g. tax-exempt bond financing trusts) established by governmental organizations. Therefore, if an enterprise has a variable interest in a governmental entity (e.g. through an operating lease containing a residual value guarantee), its variable interest falls in this scope exception. [810-10-15-12(e)]

There is an anti-abuse provision concerning financing entities. A financing entity does not fall in this scope exception if it: [810-10-15-12(e)]

- is not a governmental organization; and
- is used by the enterprise in a manner similar to a VIE in an effort to circumvent the provisions of the VIE consolidation model.

Absent the governmental organization scope exception, governmental organizations and financing entities would generally be considered VIEs because of their lack of equity at risk. However, the FASB did not intend for enterprises to consolidate organizations that are subject to accounting standards promulgated by the Federal Accounting Standards Advisory Board or the Governmental Accounting Standards Board. Further, the FASB noted that enterprises that obtain financing from government-sponsored financing entities account for their obligations under other relevant accounting pronouncements. Therefore, it concluded that it was not necessary for the VIE consolidation model to apply to those organizations. [FIN46(R).BC.D18]

We believe the governmental organization scope exception applies if a governmental entity follows the accounting standards issued by the GASB and has not elected to apply the standards issued by the FASB under the provisions of GASB Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting.

Question 2.3.190

Is a nongovernmental entity that is formed by a governmental organization exempt from being consolidated?

Interpretive response: No. A governmental organization (either domestic or foreign) is exempt from being consolidated under Topic 810. However, a nongovernmental entity (e.g. a public-private joint venture) that is formed by a governmental organization is not exempt. Therefore, the VIE and VOE consolidation models and related disclosures apply to those entities.

Similarly, we believe that GNMA I and GNMA II pools (pools of GNMA MBS issued by approved issuers and securitized under the guidelines of GNMA) are in the scope of the consolidation guidance. Therefore, we do not believe the governmental organization scope exception applies to the GNMA MBS program. See Question 6.5.90 for additional discussion.

Question 2.3.200

What is the practical effect of the anti-abuse provision regarding financing entities established by governmental organizations?

Interpretive response: In certain instances, a financing entity (such as a financing trust) may be formed by a domestic or foreign governmental organization for the specific purpose of allowing a nongovernmental enterprise to obtain lower cost financing as an incentive for the enterprise to invest in a particular governmental jurisdiction.

Under the anti-abuse provision, a financing entity that is not itself a governmental organization is subject to the VIE consolidation model if it is used by an enterprise to avoid consolidation. However, it is unlikely that a financing entity that meets all of the requisite criteria to be tax exempt could be used to avoid the VIE consolidation model without triggering the loss of its ability to issue debt with preferential tax treatment. Therefore, a financing entity that issues interest-bearing debt that qualifies to be exempt from federal taxation generally will fall outside the scope of Topic 810. [810-10-15-12(e)]

Question 2.3.210

How is the registered money market funds scope exception applied?

Background: Sponsors of registered money market funds may provide financial support to the fund for various reasons, including to keep the funds per share net asset value (NAV) from falling below $1 per share. This support may be provided in various ways, such as purchases of investments from the fund for prices greater than fair value and fee waivers. Under Topic 810, support provided voluntarily to an entity by its sponsor generally results in the sponsor having an implicit variable interest in the entity (see section 3.5). Therefore, absent the money market funds consolidation scope exception, a sponsor might conclude that it should consolidate the entity due to its implicit variable interest.

However, requiring consolidation of a money market fund by its sponsor would not have been responsive to feedback from the FASB's constituents that the sponsor's financial statements are more meaningful if the sponsor does not consolidate the fund. Instead of tailoring the consolidation model to provide a non-consolidation outcome in these unique situations, the FASB decided to add a scope exception to the consolidation requirements in Topic 810 for registered money market funds and similar entities. In connection with this decision, the FASB decided to require sponsors of such entities to include additional disclosures regarding support provided to these entities. [ASU 2015-02.BC79, BC83]

Interpretive response: An enterprise is exempt from consolidating its interest in a legal entity that is required to comply with Rule 2a-7 of 1940 Act. The scope exception also applies to a legal entity that operates under requirements that are similar to those in Rule 2a-7 (see Question 2.3.220). [810-10-15-12(f)]

A registered money market fund (MMF or Fund) is a type of mutual fund that is registered under the 1940 Act and subject to its rules, particularly Rule 2a-7. Among other things, Rule 2a-7 requires that a registered MMF:

- invest in eligible securities that have limited credit risk with remaining maturities of 397 days or less;
- maintain a dollar-weighted average maturity of 60 days or less;
- maintain a dollar-weighted average life of 120 days or less without reference to exceptions in Rule 2a-7 regarding interest rate readjustments; and
- invest no more than 5% of total assets in the same issuer.

The 1940 Act also requires registered investment funds, including registered MMFs, to establish a board of directors that elects the investment advisor and is controlled by the fund's shareholders.

If an enterprise has an interest in a legal entity subject to the money market funds scope exception, it must disclose the following: [810-10-15-12(f)(2)]

- any explicit arrangements to provide financial support to the legal entity
- any instance of financial support provided to the legal entity for the periods presented in the performance statement

Question 2.3.220

When is a legal entity 'similar' to a registered money market fund?

Excerpt from ASU 2015-02

BC82. The Board concluded that the characteristics required for consideration when conducting the "similar" evaluation are the purpose and design of the fund as well as the risks that the fund was designed to create and pass through to its interest holders. When considering the purpose and design and the risks of the fund, the Board expected that a "similar" fund would seek to maintain the principal investment by minimizing the fund's exposure to credit risk and allowing for investor redemptions from the fund on a daily basis. When considering the risks that the fund was designed to create and pass through to its interest holders, the Board expects entities to assess whether the fund's portfolio quality, maturity, and diversification are similar to a money market fund that complies with or operates in accordance with Rule 2a-7, with a focus on the following:

a. Portfolio quality: Invest in high-quality, short-term securities that are judged to present credit risk similar to investments held by a money market fund that complies with or operates in accordance with Rule 2a-7.
b. Portfolio maturity and diversification: Follow an overall objective regarding the credit quality and maximum maturity of eligible investments, the diversification of the fund's portfolio, and its overall average maturity that is consistent with a money market fund that complies with or operates in accordance with Rule 2a-7.

Background: An enterprise is exempt from consolidating its interest in a legal entity that is required to comply with Rule 2a-7 of 1940 Act (see Question 2.3.210). The scope exception also applies to a legal entity that operates under requirements that are similar to those in Rule 2a-7. [810-10-15-12(f)(1)]

The FASB addressed its views on when a legal entity is similar to a registered MMF in the basis for conclusions in ASU 2015-02. The determination of similar depends on the entity's purpose and design, including the risks the entity was designed to create and pass through to its interest holders.

Interpretive response: We believe a legal entity that is similar to a registered MFF is similar in purpose, design, and nature of risks. As discussed in section 3.3, a legal entity's purpose and design is evidenced by a variety of factors, including the contractual requirements that govern its operations, as well as its actual operations since it was established.

An entity that is similar to a registered MMF allows for investor redemptions from the fund on a daily basis at the entity's net asset value (NAV) per share and seeks to minimize the fund's exposure to credit risk in order to maintain the principal investment. While a non-registered MMF is unlikely to voluntarily comply with all of the requirements of Rule 2a-7, it is expected that the specific requirements of a non-registered MMF will not diverge significantly from the objectives of Rule 2a-7.

Except for providing for investor redemptions on a daily basis, we believe that noncompliance with an individual provision in Rule 2a-7 does not automatically disqualify an entity from being considered similar to a registered MMF. Professional judgment is required in performing the assessment.

The following discussion summarizes the current Rule 2a-7 requirements highlighted in ASU 2015-02.BC82. Apart from the 'other' conditions identified last, these requirements are mandatory for a registered MMF.

Stable price calculation

A registered MMF 'floats' its NAV – i.e. daily share prices fluctuate based on the current NAV and changes, if any, in the value using market-based factors of the underlying portfolio of securities.

Reference	Requirement
2a-7(c)(1)	Compute price per share by rounding the fund's current NAV per share subject to certain rounding considerations. As an exception, government or retail MMFs that must maintain a stable NAV and use the amortized cost method and/or penny rounding to compute the NAV or price per share.

Credit quality

A registered MMF complies with restrictions on the credit quality of its investments that are designed to limit the credit risk to the investors, based on the capacity of the issuer or guarantor of a security to meet its financial obligations.

Reference	Requirement
2a-7(d)(2)(i)	Investments are limited to 'eligible securities' that present minimal credit risks.

- Registered MMFs may invest in a security only if the fund determines that the security presents minimal credit risks after analyzing the following factors. [1940 Act, Rule 2a-7(a)(11)]
- Financial condition, which generally should include an examination of recent financial statements and consideration of trends relating to cash flow, revenue, expenses, profitability, short-term and total debt service coverage and leverage (including financial and operating leverage).
- Sources of liquidity, which generally should include a consideration of bank lines of credit and alternative sources of liquidity.
- Ability to react to future market-wide and issuer- or guarantor-specific events, including the ability to repay debt in a highly adverse situation. This factor generally should include an analysis of risk from various scenarios, including changes to the yield curve or spreads, especially in a changing interest rate environment.
- Strength of the issuer's or guarantor's industry within the economy and relative to economic trends, and issuer's or guarantor's competitive position within its industry. This factor generally should include consideration of diversification of sources of revenue, if applicable.

Maturity

A registered MMF complies with restrictions on the weighted-average portfolio maturity or weighted-average portfolio life that are not significantly different from the Rule 2a-7 requirement of 60 days or less or 120 days or less, respectively.

Reference	Requirement
2a-7(d)(1)(i)	Acquire an instrument only with a remaining maturity of 397 calendar days or less.
2a-7(d)(1)(ii)	Maintain a dollar-weighted average portfolio maturity of 60 days or less.
2a-7(d)(1)(iii)	Maintain a dollar-weighted average portfolio life of 120 days or less without reference to any 2a-7 provision that permits a fund to shorten the maturity of an adjustable-rate security by reference to its interest rate reset dates.

Diversification

A registered MMF complies with restrictions on the quantity of investments from individual issuers that results in significant diversification.

Reference	Requirement
2a-7(d)(3)(i)(1)	No more than 5% of total assets invested in one issuer.
2a-7(d)(3)(i)(2)	No more than 10% of total assets in securities issued or guaranteed by, or having demand features to, one entity.

Management oversight – overall control

Investors in a registered investment company (the shareholders) have ultimate control over the fund through the ability to elect the board of directors and/or approve the investment manager. While this requirement is not individually determinative, a non-registered MMF that has this requirement may be more likely to be similar to a registered MMF. The legal entity should have a mechanism for monitoring the investment manager's compliance with the entity's requirements.

Other conditions

A legal entity that has characteristics differing from the following is a strong indication that the legal entity is not designed to be similar to a registered MMF.

— **A single class of shareholders.** Registered MMFs do not generally have more than one class of shareholders for purposes of allocating investment risks; there may be multiple shareholder classes for purposes of determining the expenses charged to investors.

— **Debt or leverage restrictions.** Registered MMFs are restricted from borrowing funds and creating leveraged returns.

2.4 VIE scope exceptions

2.4.10 General VIE scope exceptions

Excerpt from ASC 810-10

Variable Interest Entities

> Entities

15-17 The following exceptions to the Variable Interest Entities Subsections apply to all legal entities in addition to the exceptions listed in paragraph 810-10-15-12:

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

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

    This inability to obtain the necessary information is expected to be infrequent, especially if the reporting entity participated significantly in the design or redesign of the legal entity. The scope exception in this provision applies only as long as the reporting entity continues to be unable to obtain the necessary information. Paragraph 810-10-50-6 requires certain disclosures to be made about interests in VIEs subject to this provision. Paragraphs 810-10-30-7 through 30-9 provide transition guidance for a reporting entity that subsequently obtains the information necessary to apply the Variable Interest Entities Subsections to a VIE subject to this exception.
d. A legal entity that is deemed to be a **business** need not be evaluated by a reporting entity to determine if the legal entity is a VIE under the requirements of the Variable Interest Entities Subsections unless any of the following conditions exist (however, for legal entities that are excluded by this provision, other generally accepted accounting principles [GAAP] should be applied):

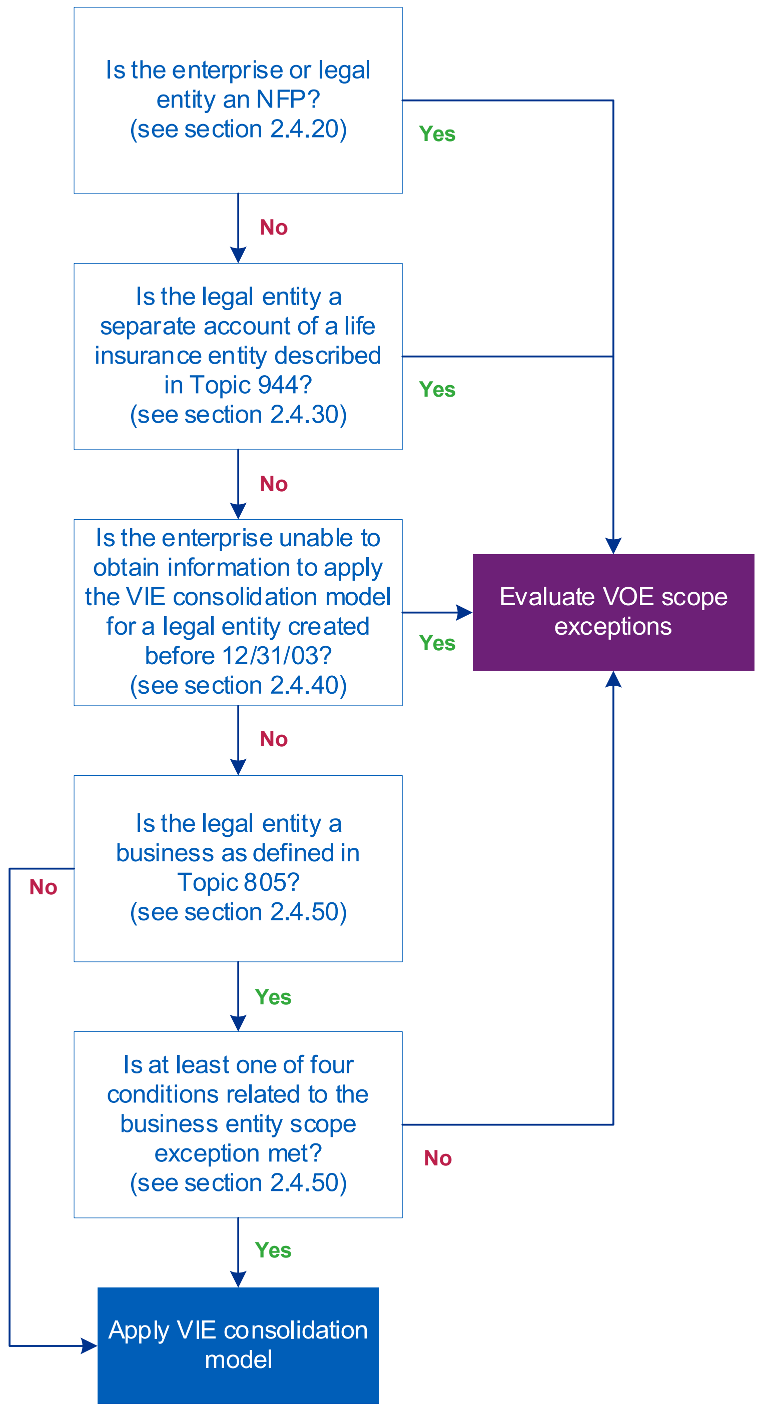
1. The reporting entity, its related parties (all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d)), or both participated significantly in the design or redesign of the legal entity. However, this condition does not apply if the legal entity is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

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

If an enterprise or legal entity does not qualify for a consolidation scope exception (see section 2.3), it may qualify for a scope exception to the VIE consolidation or VOE consolidation model.

Question 2.4.10
What are the VIE scope exceptions?

Interpretive response: The following decision tree summarizes the VIE scope exceptions.



Question 2.4.20
Can the VIE scope exceptions be applied by analogy?

Interpretive response: No. The VIE scope exceptions apply only to those enterprises and legal entities specifically referenced in those scope exceptions. For example, a separate account of an insurance company does not fall in the VIE scope exception for such accounts if the insurer is not a life insurance entity as described in the AICPA Audit and Accounting Guide, Life and Health Insurance Entities (see section 2.4.30).

2.4.20 NFP VIE scope exception

Excerpt from ASC 810-10

20 Glossary

Not-for-Profit Entity – An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

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

Entities that clearly fall outside this definition include the following:

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

The NFP VIE scope exception applies when: [810-10-15-17(a)]

— a for-profit enterprise has a controlling financial interest in an NFP; or
— an NFP enterprise has a controlling financial interest in a for-profit entity or another NFP.

Question 2.4.30
What is the appropriate accounting when an enterprise is a for-profit entity vs an NFP?

Interpretive response: The following table indicates the appropriate accounting when an enterprise is a for-profit entity versus an NFP.

Enterprise is:	Legal entity is a for-profit entity:	Legal entity is an NFP:
For-profit	Apply Topic 810 in its entirety	Apply the VOE consolidation model[1]
NFP	Apply Subtopic 958-810's consolidation model[2]	

Notes:

1. The VOE consolidation model applies in this instance because the NFP VIE scope exception applies. However, if the anti-abuse provision is triggered, the enterprise applies Topic 810 in its entirety (see Question 2.4.40).
2. Subtopic 954-810 (health care entities) provides incremental presentation and disclosure guidance for NFPs in its scope.

See Question 2.4.60 for additional guidance on NFP consolidation.

Question 2.4.40
How is the anti-abuse provision to the NFP VIE scope exception applied?

Interpretive response: Under an anti-abuse provision, the NFP VIE scope exception does not apply if an NFP is being used like a VIE by a for-profit enterprise to circumvent the VIE consolidation model. Therefore, if the anti-abuse provision applies, a for-profit enterprise must apply Topic 810 in its entirety to an NFP instead of only the VOE consolidation model.

Determining whether the anti-abuse provision applies depends on the specific facts and circumstances and requires an assessment of management's intent. Examples 2.4.10 and 2.4.20 illustrate the analysis required to apply the anti-abuse provision. [810-10-15-17(a)]

Example 2.4.10
Charitable foundation as lessor

Background

Enterprise wants to lease an aircraft from a lessor trust created specifically to facilitate the financing of the particular transaction. However, Enterprise concludes that even though the lease is an operating lease, the lessor trust would be a VIE that Enterprise would have to consolidate based on the terms of the lease. As a result, Enterprise modifies the transaction structure so that the principal lender's charitable foundation becomes the aircraft lessor and Enterprise leases the aircraft from the charitable foundation.

Evaluation

Because Enterprise is using the lender's charitable foundation to avoid consolidation under the VIE consolidation model, the anti-abuse provision applies. Therefore, Enterprise applies Topic 810 in its entirety when evaluating its involvement with the charitable foundation.

Example 2.4.20
Political action committee

Background

Enterprise establishes a Political Action Committee (PAC) to accept voluntary contributions from executive employees, directors and shareholders for disbursement to political candidates who have taken responsible positions on issues affecting Enterprise. In accordance with its bylaws, Enterprise cannot make contributions to the PAC.

The PAC operates as a tax-exempt political organization within the meaning of Section 527(e)(1) of the Internal Revenue Code. It is not organized for profit and no part of net earnings benefit Enterprise or Enterprise's employees or board of directors. In the event of dissolution, assets of the PAC will be transferred to another qualifying NFP. The PAC has no members or capital stock. The affairs of the PAC are managed by its board of directors, which is appointed by Enterprise's CEO. The board members have the authority to make changes to the bylaws and dissolve the PAC.

Evaluation

NFP definition

Enterprise first evaluates whether the PAC qualifies for the NFP scope exception. The PAC meets the definition of an NFP because:

- the PAC will receive assets/resources from resource providers who will not receive a direct return or benefit;
- the operating purpose of the PAC is not to provide goods or services at a profit but rather to support political activities; and
- the PAC does not have ownership interests like those of a business.

Further, the PAC does not benefit any member of the PAC board of directors and Enterprise will not receive a commensurate or pecuniary return in any case, including in the event of the PAC's dissolution. Further, Political Action Committees are included in the list of NFPs in paragraph 958-10-15-3.

Therefore, Enterprise concludes that PAC meets the definition of an NFP.

Anti-abuse provision

However, for the scope exception to apply, Enterprise also needs to conclude that the PAC is not being used like a VIE to circumvent the Subtopic 810-10 VIE provisions.

In this example, we believe Enterprise can support application of the scope exception because the PAC is not being used in a similar manner to a VIE and Enterprise will not absorb expected losses or receive expected residual returns of the PAC. Shareholders and employees that contribute to the PAC share collectively with Enterprise in potential benefits associated with the PAC (i.e. Enterprise alone does not directly realize any of the potential benefits). Further, the benefits received are indirect and intangible given that a favorable political or other action is not the direct result of a distribution.

We understand that some may have taken an alternative view that the PAC is being used by Enterprise in a manner similar to a VIE to circumvent the VIE consolidation model because:

— the PAC's Board consists solely of members of Enterprise's management;
— the PAC's Board determines the recipients of the political contributions; and
— the PAC solely benefits Enterprise.

However, under this view, Enterprise cannot consolidate the PAC unless it has a variable interest in the PAC. If Enterprise is identified as the single decision-maker via its CEO's ability to appoint the Board, it applies the guidance on decision maker fees to determine whether it has a variable interest in the PAC (see section 3.8).

If Enterprise does have a variable interest, it likely would be the PAC's primary beneficiary because the primary beneficiary criteria likely would be met (see section 6.2).

Question 2.4.50

Does an enterprise identify an NFP as a related party for purposes of applying the VIE consolidation model even if the NFP meets the scope exception?

Background: An enterprise with a variable interest in a VIE may need to consolidate the VIE because one or more of its related parties also has a variable interest in the VIE.

For example, a single decision-maker that has a variable interest must include its direct interests in the VIE and its indirect interests held through related parties when evaluating whether its obligation to absorb losses or right to receive benefits could be potentially significant to the VIE (see section 6.6.20). Further, if no individual enterprise meets the primary beneficiary criteria but a related party group collectively does through shared power or common control, one enterprise in the group must consolidate under the related-party tie-breaker (see section 6.5.30).

Interpretive response: Yes. An NFP may be a related party of an enterprise for purposes of evaluating whether the enterprise should consolidate a VIE. The determination of who in a related party group, if any, should consolidate a VIE is addressed in section 6.5.30. For example, an NFP could be a related party of an enterprise if the enterprise contributed the variable interest(s) held by the NFP in a legal entity.

Therefore, an NFP could cause an enterprise to have to consolidate a VIE because of a related party relationship with the enterprise. However, the NFP would not apply the VIE consolidation model in its financial statements (see Question 2.4.30).

Question 2.4.60

What guidance should an NFP enterprise apply to determine if it consolidates a legal entity that has one or more VIE characteristics?

Interpretive response: NFP enterprises are not generally subject to the VIE consolidation model. Instead, they apply one of the following in Subtopic 958-810:

- general consolidation guidance; or
- consolidation guidance that explicitly applies when the legal entity is an SPE lessor entity (see chapter 9).

We believe NFP enterprises should apply the guidance specific to special-purpose lessor entities by analogy when evaluating whether to consolidate any type of SPE. The general consolidation guidance applies when the legal entity is not an SPE. [810-10-15-17(a), 958-810-25-8 – 25-10, 55-7 – 55-16]

What is an SPE?

The FASB expects the term 'special purpose entity' to include any entity whose activities are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.

Question 2.4.70

Does a for-profit subsidiary of an NFP parent apply the NFP VIE scope exception when evaluating whether it should consolidate a for-profit entity?

Interpretive response: No. A subsidiary of an NFP that has a relationship with a for-profit VIE must itself meet the definition of an NFP in Subtopic 810-10 to use the NFP scope exception. Unless other scope exceptions apply, these for-profit subsidiaries are required to evaluate relationships with VIEs under the VIE consolidation model. [810-10 Glossary]

Further, although an NFP parent generally does not apply the VIE consolidation model to its direct interests, it should retain the VIE accounting applied by its for-profit subsidiary when it prepares its consolidated financial statements (see Question 7.4.40).

2.4.30 Life insurance entity VIE scope exception

The FASB exempts separate accounts of life insurance entities from the scope of the VIE consolidation model because existing accounting standards address those accounts. [810-10-15-17(b)]

Specifically, the following accounts are usually reported as summary totals in a life insurance entity's financial statements: [944-80-45-1]

- separate account assets – i.e. the net assets of the separate account; and
- liabilities – i.e. the insurance enterprise's obligation to the separate account holders.

The investors in those separate accounts are exempt from consolidating the accounts.

Question 2.4.80

What constitutes separate accounts of a life insurance entity?

Interpretive response: The life insurance entity scope exception applies only to separate accounts of life insurance entities, described as follows in AICPA Audit and Accounting Guide, Life and Health Insurance Entities. [AAG-LHI.13.17]

Separate accounts represent assets and liabilities that are maintained by an insurance entity and are established primarily for the purpose of funding:

- variable annuity contracts;
- variable life insurance contracts;
- modified guaranteed annuity contracts;
- modified guaranteed life insurance contracts; or
- other various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability.

SSAP No. 56, Separate Accounts, states, "When separate accounts are established and filed accordingly, they may be used to fund guaranteed benefits. Separate account contracts may also be used to accumulate funds which are intended to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options." [SSAP 56.2]

Question 2.4.90

Are investees of separate accounts exempt from consolidation?

Interpretive response: No. The life insurance VIE scope exception exempts a life insurance company from consolidating its separate accounts. A separate account must evaluate the scope exceptions and guidance in Topic 810 for purposes of preparing its separate financial statements.

2.4.40 Information-out VIE scope exception

The information-out VIE scope exception applies when: [810-10-15-17(c)]

- the legal entity was created before December 31, 2003; and
- the enterprise has made exhaustive but unsuccessful efforts to obtain information necessary to:

- determine whether it is required to consolidate the legal entity under the VIE consolidation model; or
- apply VIE consolidation accounting (assuming it can determine that it should consolidate the legal entity as a VIE).

An enterprise's exhaustive efforts must continue as long as the information out scope exception is applied. If information necessary to apply the VIE consolidation model subsequently becomes available, the enterprise must reevaluate at that date its interest under Topic 810, including the applicability of the VIE Subsections. [810-10-30-7]

When this scope exception applies, an enterprise must comply with the disclosure requirements under paragraph 810-10-50-6 (see section 8.3).

Question 2.4.100

What constitutes exhaustive efforts under the information-out VIE scope exception?

Interpretive response: There is no guidance in Subtopic 810-10 about what constitutes exhaustive efforts. Certainly, serious efforts must continue to be made. However, we understand that the FASB does not, for example, expect an enterprise to resort to legal action to obtain information that it has no contractual right to receive, unless that right has been withheld deliberately to avoid the VIE provisions of Subtopic 810-10.

In commenting on its expectations, the SEC staff indicated that it can be expected to consider whether registrants operating in the same industry with similar types of arrangements were able to obtain the requisite information. [2003 AICPA Conf]

Determining when exhaustive efforts have occurred without successfully obtaining the required information will necessarily depend on the applicable facts and circumstances. An enterprise that applies this scope exception should document its efforts to obtain the necessary information.

The SEC staff has also commented that an enterprise should be able to demonstrate that it made exhaustive efforts to obtain the necessary information. [2004 AICPA Conf]

Question 2.4.110

What are the FASB's expectations concerning use of the information-out VIE scope exception?

Interpretive response: The FASB has indicated that it expects this scope exception to be used infrequently, especially if the enterprise was involved in the formation or restructuring of the legal entity. An enterprise holding a variable interest in a legal entity that exposes it to substantial risks would normally obtain information about the legal entity to monitor its exposure (even if the exposure is limited). [FIN 46(R).BC.D12]

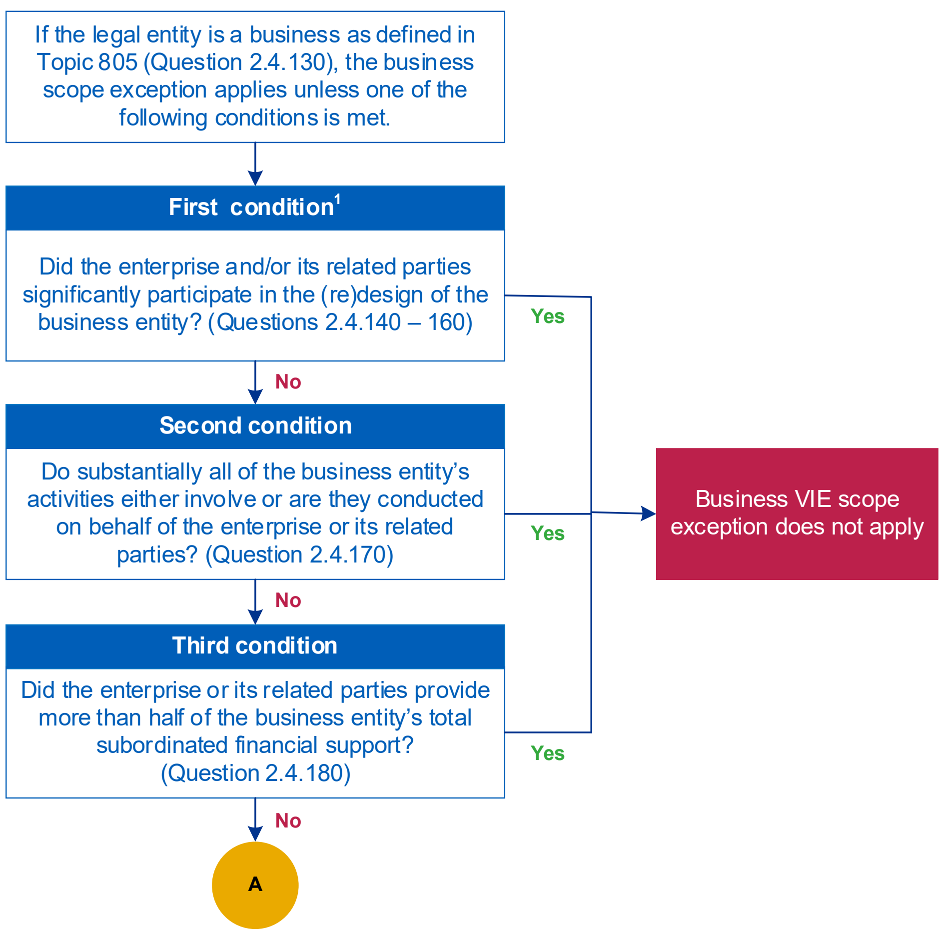
2.4.50 Business VIE scope exception

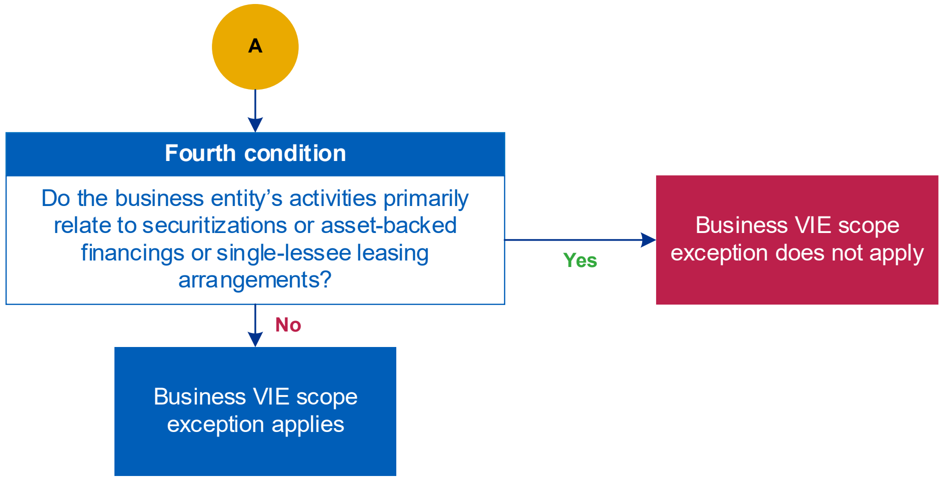
An enterprise is not required to evaluate a legal entity under the VIE consolidation model if the entity is a business and none of four conditions are met. This scope exception exists because in most instances the VOE consolidation model is likely to be more effective in determining whether an enterprise has a controlling financial interest in a business legal entity. However, the four conditions in this scope exception represent instances in which the VIE consolidation model likely is more effective in determining whether the enterprise has a controlling financial interest in the business legal entity. [810-10-15-17(d)]

Question 2.4.120

What are the requirements of the business VIE scope exception?

Interpretive response: The following decision tree summarizes the business VIE scope exception. [810-10-15-17(d)]





Note:

1. The first condition does not apply if the business entity is:
   - an operating JV under joint control of the enterprise and one or more independent parties (see Question 2.4.150); or
   - a franchisee (see Question 2.4.160).

Question 2.4.130
What is the definition of a business?

Interpretive response: In summary, a business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits. To qualify as a business, a set of assets and activities must have at least one input and one substantive process that together significantly contribute to the ability to create outputs. [805-10-55-3A, 55-5]

For in-depth guidance on whether a set of assets and activities is a business, see section 2 (from paragraph 2.026) of KPMG Handbook, Business combinations.

Question 2.4.140
How is the participation in design condition applied (first condition)?

Interpretive response: The first business scope exception condition exists if the enterprise and/or its related parties significantly participated in the design or redesign of the business entity. If this condition exists, the business scope exception does not apply.

An enterprise's determination of whether it participated significantly in the design or redesign of an entity should consider all relevant facts and circumstances. We believe the phrase 'design or redesign' of the entity refers to the nature and selection of:

— the activities in which the entity is engaged;
— the entity's legal structure; or
— the entity's variable interests.

For example, a change in the entity's legal structure or in its variable interests represents a redesign event even if there is no change in the activities in which the entity is engaged.

In general, we believe a variable interest holder participates significantly in the design or redesign of a business entity when the variable interest holder:

— obtains new or recently issued variable interests in the entity that are significant to the entity;

— is involved in creating the entity or changing its governing documents or structure – e.g. by having the right to approve the entity's governing documents or changes to those documents; or

— is involved in selecting or approving the activities in which the entity is engaged or changes to those activities regardless of whether other parties are also involved in those activities.

Further, similar involvement with a business entity by the variable interest holder's related parties generally constitutes significant participation in the entity's design or redesign.

Question 2.4.150

What type of entity is considered an operating JV (first condition)?

Interpretive response: The first business scope exception condition does not apply if the business entity is an operating JV under joint control of the enterprise and one or more independent parties. Therefore, if the business entity is such a venture, the first condition will not prohibit use of the business scope exception (although other conditions might). [810-10-15-17(d)(1)]

We believe the most appropriate definition of a JV for purposes of this first condition is in the 1979 AICPA Issues Paper, Joint Venture Accounting. In paragraph 51(b) of that Issues Paper, the AICPA's Accounting Standards Executive Committee (AcSEC) concluded that a joint venture is:

> ...an arrangement whereby two or more parties (the venturers) jointly control a specific business undertaking and contribute resources towards its accomplishment. The life of the joint venture is limited to that of the undertaking which may be of short- or long-term duration depending on the circumstances. A distinctive feature of a JV is that the relationship between the venturers is governed by an agreement (usually in writing) which establishes joint control. Decisions in all areas essential to the accomplishment of a JV require the consent of the venturers, as provided by the agreement; none of the individual venturers is in a position to

unilaterally control the venture. This feature of joint control distinguishes investments in JVs from investments in other enterprises where control of decisions is related to the proportion of voting interests held.

Although the AcSEC definition of a JV is not Codified, we believe it provides relevant guidance for determining whether a legal entity is a JV. Under the definition, joint control over the decision-making of an entity is the key consideration in evaluating whether the entity is a JV. Joint control involves joint decision making over all key decisions, including significant acquisitions and dispositions, and the issuance or repurchase of equity interests. We believe this type of arrangement is distinguishable from other arrangements in which parties involved with an entity share equally in its economic risks and rewards but not in the decisions about its activities. Put or call options between or among parties may affect whether the entity is a JV that is subject to joint control similar to the way in which such a call option affects whether participating rights are substantive. For example, if one party has a call option on the other party's interest and exercise of the option is prudent, feasible and substantially within that party's control, the legal entity likely is not a JV subject to joint control (see section 5.2).

We believe a corporate JV, as that term is defined in Topic 323 (equity method), is not necessarily an operating JV under joint control. Although a corporate JV usually provides its venturers the ability to participate in the overall management of the venture, it does not require joint control. [323-10 Glossary]

Question 2.4.160

When is a business entity a franchisee (first condition)?

Excerpt from ASC 952-10

20 Glossary

Franchise Agreement – A written business agreement that meets the following principal criteria:

a. The relation between the franchisor and franchisee is contractual, and an agreement, confirming the rights and responsibilities of each party, is in force for a specified period.
b. The continuing relation has as its purpose the distribution of a product or service, or an entire business concept, within a particular market area.
c. Both the franchisor and the franchisee contribute resources for establishing and maintaining the franchise. The franchisor's contribution may be a trademark, a company reputation, products, procedures, manpower, equipment, or a process. The franchisee usually contributes operating capital as well the managerial and operational resources required for opening and continuing the franchised outlet.

d. The franchise agreement outlines and describes the specific marketing practices to be followed, specifies the contribution of each party to the operation of the business, and sets forth certain operating procedures that both parties agree to comply with.
e. The establishment of the franchised outlet creates a business entity that will, in most cases, require and support the full-time business activity of the franchisee. (There are numerous other contractual distribution agreements in which a local businessperson becomes the authorized distributor or representative for the sale of a particular good or service, along with many others, but such a sale usually represents only a portion of the person's total business).
f. Both the franchisee and the franchisor have a common public identity. This identity is achieved most often through the use of common trade names or trademarks and is frequently reinforced through advertising programs designed to promote the recognition and acceptance of the common identity within the franchisee's market area.

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

Interpretive response: The first business scope exception condition does not apply if the business entity is a franchisee. Therefore, if a business entity is a franchisee, the first condition will not prohibit it from use of the business VIE scope exception. [810-10-15-17(d)(1)]

We believe this franchise exception applies only if the business entity meets the definition of a franchise under Topic 952 (franchisors). Under this definition, a franchisee is a party that has been granted business rights to operate a franchised business in a franchise agreement with a franchisor (the party that grants the rights to operate the franchised business). [952-10 Glossary]

Question 2.4.170

How is the substantially all condition applied (second condition)?

Interpretive response: The second business scope exception applies if substantially all of a business entity's activities either involve or are conducted on behalf of an enterprise (i.e. the variable interest holder) and its related parties. [810-10-15-17(d)(2)]

Practice has interpreted 'substantially all' under Topic 860 to mean 90% or more; however, less than 90% is not necessarily a safe harbor. Therefore, applying this second condition requires judgment and consideration of all relevant facts and circumstances.

We believe evaluation of this second condition should be consistent with the evaluation of the disproportionality characteristic, which is a characteristic of a VIE. The disproportionality characteristic applies when substantially all of a legal entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights.

This characteristic is discussed in section 4.7; in particular, Question 4.7.60 discusses considerations we believe should be included in the analysis of both the disproportionality characteristic and this second condition under the business scope exception.

Question 2.4.180

How is the subordinated support condition applied (third condition)?

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

>>> Equity Investments, Beneficial Interests, and Debt Instruments

55-23 Investments in subordinated beneficial interests or subordinated debt instruments issued by a VIE are likely to be variable interests. The most subordinated interest in a VIE will absorb all or part of the expected losses of the VIE. For a voting interest entity the most subordinated interest is the entity's equity; for a VIE it could be debt, beneficial interests, equity, or some other interest. The return to the most subordinated interest usually is a high rate of return (in relation to the interest rate of an instrument with similar terms that would be considered to be investment grade) or some form of participation in residual returns.

55-24 Any of a VIE's liabilities may be variable interests because a decrease in the fair value of a VIE's assets could be so great that all of the liabilities would absorb that decrease. However, senior beneficial interests and senior debt instruments with fixed interest rates or other fixed returns normally would absorb little of the VIE's expected variability. By definition, if a senior interest exists, interests subordinated to the senior interests will absorb losses first. The variability of a senior interest with a variable interest rate is usually not caused by changes in the value of the VIE's assets and thus would usually be evaluated in the same way as a fixed-rate senior interest. Senior interests normally are not entitled to any of the residual return.

Interpretive response: The third business scope exception condition applies if the enterprise or its related parties provide more than half of the business entity's subordinated financial support. Applying this condition is a two-step process [810-10-15-17(d)(3)]

Step 1	Identify the business entity's subordinated financial support.
Step 2	Determine if the enterprise or its related parties have provided more than half of that support.

Step 1: Identify the subordinated financial support

In general, we believe subordinated financial support includes principally the items that a business entity's capital comprises (e.g. equity and debt). However, not all debt is subordinated financial support.

The business VIE scope exception specifically refers to subordinated debt as a form of subordinated financial support but does not mention senior debt as a form of subordinated financial support. Further, Subtopic 810-10's definitions of variable interests and subordinated financial support suggest that not all variable interests represent subordinated financial support. Specifically, the Subtopic's glossary states, "Subordinated financial support refers to variable interests that will absorb some or all of an entity's expected losses." [810-10 Glossary, 810-10-55-23 – 55-24]

Based on this definition, we believe such support generally excludes:

— most senior debt; and
— guarantees or similar instruments provided to or for the business entity, such as off market contracts, commitments to fund losses and derivatives.

We believe subordinated interests (other than interests considered equity at risk) are not subordinated financial support when they are not needed for the business entity to finance its activities based solely on the sufficiency of its equity (see section 4.3.40). In general, we also believe senior debt is subordinated financial support if it has terms and interest rates that indicate that the debt is not of a quality equivalent to investment grade (see section 3.4.10).

Step 2: Determine if more than half of the subordinated financial support is provided by the enterprise

After an enterprise identifies a business entity's subordinated financial support, it determines the total fair value of that amount, including the fair value of the entity's total equity. If the enterprise has provided more than 50% of that total, the third condition is triggered, and the business scope exception does not apply.

Question 2.4.190

Does each variable interest holder need to separately evaluate whether the business scope exception conditions are met?

Interpretive response: Yes. Each of a legal entity's variable interest holders should separately evaluate its eligibility for the business scope exception. It is inappropriate for an enterprise to base its conclusion about whether it is eligible for the business scope exception on another enterprise's evaluation of its eligibility for that exception.

Each reporting enterprise is responsible for reaching its own judgments and conclusions because the analysis of the business scope exception conditions depends in part on enterprise-specific factors. For example, the second condition depends on whether substantially all of the entity's activities either involve or are conducted on behalf of the enterprise or its related parties.

Question 2.4.200

In subsequent periods, when is an enterprise required to reevaluate whether the business scope exception applies?

Interpretive response: We believe the timing for an enterprise to reevaluate whether the business scope exception applies depends on whether it is currently applying the exception.

Enterprise is currently applying the business scope exception

We believe an enterprise should continuously evaluate its eligibility for the business scope exception as the factors affecting the exception's four conditions change. If at each evaluation date, none of the conditions are met, we believe the enterprise can continue to apply the business scope exception. In this instance, we believe the enterprise is not required to reevaluate whether the legal entity is a business because being a business is not one of the four conditions under the scope exception.

Enterprise is not currently applying the business scope exception

If a reporting entity currently is not eligible for the business scope exception, it must reassess whether it meets the exception's four conditions only when events occur that require reconsideration of whether the legal entity is a VIE under paragraph 810-10-35-4 (see section 4.8).

2.5 VOE scope exceptions

Excerpt from ASC 810-10

General

> Entities

15-3 All reporting entities shall apply the guidance in the Consolidation Topic to determine whether and how to consolidate another entity and apply the applicable Subsection as follows:

a. If the reporting entity has an interest in an entity, it must determine whether that entity is within the scope of the Variable Interest Entities Subsections in accordance with paragraph 810-10-15-14. If that entity is within the scope of the Variable Interest Entities Subsections, the reporting entity should first apply the guidance in those Subsections. Paragraph 810-

10-15-17 provides specific exceptions to applying the guidance in the Variable Interest Entities Subsections.

b. If the reporting entity has an interest in an entity that is not within the scope of the Variable Interest Entities Subsections and is not within the scope of the Subsections mentioned in paragraph 810-10-15-3(c), the reporting entity should use only the guidance in the General Subsections to determine whether that interest constitutes a controlling financial interest.
c. If the reporting entity has a contractual management relationship with another entity that is not within the scope of the Variable Interest Entities Subsections, the reporting entity should use the guidance in the Consolidation of Entities Controlled by Contract Subsections to determine whether the arrangement constitutes a controlling financial interest.

15-10 A reporting entity shall apply consolidation guidance for entities that are not in the scope of the Variable Interest Entities Subsections (see the Variable Interest Entities Subsection of this Section) as follows:

a. All majority-owned subsidiaries—all entities in which a parent has a controlling financial interest—shall be consolidated. However, there are exceptions to this general rule.

    1. A majority-owned subsidiary shall not be consolidated if control does not rest with the majority **owner**—for instance, if any of the following are present:

        i. The subsidiary is in legal reorganization
        ii. The subsidiary is in bankruptcy
        iii. The subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary.
        iv. In some instances, the powers of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling shareholder or limited partner (hereafter referred to as noncontrolling rights). In paragraphs 810-10-25-2 through 25-14, the term *noncontrolling shareholder* refers to one or more noncontrolling shareholders and the terms *limited partner* and *general partner* refer to one or more limited or general partners. Those noncontrolling rights may have little or no impact on the ability of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the investee's operations or assets, or, alternatively, those rights may be so restrictive as to call into question whether control rests with the majority owner.
        v. Control exists through means other than through ownership of a majority voting interest or a majority of kick-out rights through voting interests, for example as described in (c) through (e).

    2. A majority-owned subsidiary in which a parent has a controlling financial interest shall not be consolidated if the parent is a broker-dealer within the scope of Topic 940 and control is likely to be temporary.

3. Subparagraph superseded by Accounting Standards Update No. 2013-08.

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

Excerpt from ASC 810-10

Consolidation of Entities Controlled by Contract

05-14 The Consolidation of Entities Controlled by Contract Subsections provide guidance on the consolidation of entities controlled by contract that are not determined to be **variable interest entities** (VIEs) (see the Variable Interest Entities Subsection of Section 810-10-15). As indicated in paragraph 810-10-15-19, the guidance in the Consolidation of Entities Controlled by Contract Subsections is to be applied to all entities controlled by contract, despite the fact that the context of the guidance is physician practice management entities.

05-15 Contractual arrangements between entities that are in business to practice and dispense medicine (physician practices) and entities that are in business to manage the operations of those physician practices (physician practice management entities) are becoming increasingly common. The structure of those arrangements takes various forms, provides for varying degrees of participation in the management of the physician practice by the physician practice management entity, and provides for various financial arrangements.

05-16 Many of the arrangements between physician practices and physician practice management entities arise when the physician practice management entity seeks to acquire the physician practice. Legal or business reasons often preclude the physician practice management entity from acquiring the physician practice's outstanding equity instruments and, if that is the case, then, as an alternative, the physician practice management entity often will acquire some or all of the net assets of the physician practice, assume some or all of the contractual rights and responsibilities of the physician practice, and execute a long-term management agreement to operate the physician practice with the owners of the physician practice (typically the physicians) receiving consideration in exchange. In addition to obtaining a long-term management agreement, the physician practice management entity often will secure the future services of individual physicians employed in the physician practice through employment and noncompete agreements.

The VOE scope exceptions are the last to be evaluated – after the consolidation and VIE scope exceptions (see sections 2.3 and 2.4). Because the VIE scope exceptions are evaluated before the VOE scope exceptions, an enterprise evaluates the VOE scope exceptions if a legal entity: [810-10-15-3]

- is not a VIE; or
- a VIE scope exception applies.

Question 2.5.10
When is the VOE consolidation model applied?

Interpretive response: The VOE consolidation model has its own scope and scope exceptions. Generally, this model applies to majority-owned subsidiaries that are not subject to the VIE consolidation model or are not VIEs. Majority-owned in this instance means the enterprise has a controlling financial interest in a subsidiary, as defined by Topic 810 (see chapter 5).

However, the following are scope exceptions to this general consolidation principle: [810-10-15-10]

- control does not rest with the majority owner (see section 5.2);
- the parent is a broker-dealer in the scope of Topic 940 and control over the majority-owned subsidiary is likely to be temporary;
- the legal entity is an R&D arrangement
- the enterprise and legal entity have a contractual relationship that is in the scope of the Consolidation of Entities Controlled by Contract Subsections of Subtopic 810-10 (see Question 2.5.100).

Question 2.5.20
Does an enterprise evaluate majority- and wholly-owned subsidiaries under the VIE consolidation model?

Interpretive response: Yes. An enterprise should evaluate a legal entity to determine if it is a VIE (and whether it is the primary beneficiary) even if the enterprise owns all or a majority of its voting shares. Therefore, the VIE consolidation model can apply even if a legal entity otherwise would be consolidated under the VOE consolidation model.

If the majority- or wholly-owned legal entity is a VIE, the enterprise does not consolidate the entity if it does not meet the primary beneficiary criteria. If the enterprise does meet the primary beneficiary criteria (and therefore consolidates the legal entity), it is subject to different disclosure requirements under the VIE consolidation model (see chapter 8).

Question 2.5.30

Should a parent that files for bankruptcy continue to consolidate a subsidiary that has not?

Interpretive response: Generally, yes. The parent generally retains control over the subsidiary even if it has filed a petition for Chapter 11 bankruptcy protection and is itself controlled by the Bankruptcy Court. This is because the subsidiary has not filed for bankruptcy and therefore is not controlled by the Court.

See KPMG Handbook, Accounting for bankruptcies, Question 4.11.20.

Question 2.5.40

Should a parent continue to consolidate a majority-owned subsidiary after the subsidiary files for bankruptcy?

Interpretive response: Generally, no. Topic 810 specifically prohibits consolidation of a majority-owned subsidiary if control does not rest with the majority owner due to, among other things, legal reorganization or bankruptcy of the subsidiary. Topic 810 also indicates that a subsidiary should be deconsolidated if, among other things, the subsidiary becomes subject to the control of a government, Bankruptcy Court, administrator or regulator. [810-10-15-10, 55-4A]

Operating while in bankruptcy usually indicates that control does not rest with the majority owner because the Bankruptcy Court must approve all significant actions. As a result, deconsolidation of the subsidiary is appropriate in most cases (see section 7.7).

Concluding that continued consolidation of a subsidiary in bankruptcy is appropriate requires a fairly unique set of facts and is appropriate only in infrequent and uncommon circumstances.

See KPMG Handbook, Accounting for bankruptcies, Question 4.11.40 for additional guidance.

Question 2.5.50

Is a parent's loss of control due to a subsidiary's bankruptcy filing after year-end a recognized subsequent event?

Interpretive response: No. We believe the bankruptcy petition filing after year-end is a nonrecognized subsequent event. Further, Topic 810 states that a parent company deconsolidates a subsidiary "…as of the date [it] ceases to have a controlling financial interest…" As a result, the parent continues to consolidate the subsidiary as of year-end. [810-10-40-4]

The parent should include appropriate disclosure of the subsequent event in the year-end financial statements.

See also KPMG Handbook, Accounting for bankruptcies, Question 4.11.60.

Question 2.5.60

Should a parent continue to consolidate a subsidiary after both have filed for bankruptcy?

Interpretive response: It depends. As discussed in Question 2.5.50, the parent should continue to consolidate only if it maintains control over the subsidiary. When an entity files for bankruptcy, control usually rests with the Bankruptcy Court and not with the parent. When this is the case, deconsolidation is appropriate.

Whether the parent maintains control over the subsidiary depends on whether the consolidated entity files a single bankruptcy petition or the parent and subsidiary file separate bankruptcy petitions. When there is a single petition in a single jurisdiction, continued consolidation is appropriate if the Bankruptcy Court views the consolidated entity as a single group. In contrast, if the entities file separate petitions or they file petitions in separate jurisdictions, then the parent likely has lost control over the subsidiary and deconsolidation is appropriate.

See KPMG Handbook, Accounting for bankruptcies, Question 4.11.120.

Question 2.5.70

Can an other-than-temporary lack of exchangeability between two currencies affect whether a majority-owned foreign subsidiary should be consolidated?

Interpretive response: Yes. If a lack of exchangeability between two currencies is other than temporary, the appropriateness of consolidating the foreign operation should be carefully evaluated. This evaluation should consider whether the parent still controls, or has significant influence over, the foreign operation. A majority-owned subsidiary should not be consolidated if control does not rest with the majority owner. For example, control may not rest with the majority owner (parent) if the subsidiary operates under foreign exchange restrictions, controls or other government-imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary. [810-10-15-10]

This limitation to consolidation should also be applied as a limitation to the use of the equity method. In these situations, which historically have been rare, the investment should be accounted for under Topic 321 (equity securities). See 2.4.30 of KPMG Handbook, Equity method of accounting.

Question 2.5.80

What guidance does an NFP enterprise apply when consolidating a majority-owned subsidiary?

Interpretive response: Subtopic 958-810 provides incremental guidance that an NFP enterprise must consider when applying the VOE consolidation model. For example, it defines control in certain relationships between an NFP enterprise and another entity. Further, it provides guidance on presenting consolidated entities in an NFP enterprise's financial statements. See chapter 9. [810-10-15-5]

Subtopic 954-810 provides incremental presentation and disclosure guidance for NFPs in its scope.

Question 2.5.90

Does the VOE consolidation model apply to R&D arrangements?

Interpretive response: No, not if the relationship between the enterprise and the legal entity is in the scope of Subtopic 810-30. Subtopic 810-30 contains the consolidation model for R&D arrangements that are not VIEs. [810-10-15-10(c), 810-30-15-3(b)]

Although Subtopic 810-30 applies to a non-VIE legal entity that is in its scope, in our experience it is unusual to identify such an entity. Most are VIEs because the entities in the scope of Subtopic 810-30 involve some equity owners with no voting rights and disproportionality between equity owners.

Question 2.5.100

Does the VOE consolidation model apply when the legal entity is controlled by contract?

Interpretive response: No, not if the relationship between the enterprise and the legal entity falls in the scope of the Consolidation of Entities Controlled by Contract Subsections of Subtopic 810-10. These Subsections provide an alternative to consolidation under the VOE consolidation model. [810-10-15-19]

However, these Subsections do not replace the VIE consolidation model. Therefore, if the legal entity is a VIE, the enterprise applies the VIE consolidation model.

Although the Consolidation of Entities Controlled by Contract Subsections apply to a non-VIE legal entity that is in the scope of those Subsections, in our experience it is rare to identify such an entity. As a result, we believe that the Consolidation of Entities Controlled by Contract Subsections are applied only by enterprises that are exempt from the VIE consolidation model – e.g. NFPs.

Question 2.5.110

Does the VOE consolidation model apply when the legal entity is a rabbi trust?

Interpretive response: No, not if the rabbi trust falls in the scope of the rabbi trust Subsections of Subtopic 710-10 (compensation). These Subsections require the employer to consolidate the plans in their scope. [710-10-25-15 – 25-18, 45-1]

However, these Subsections do not replace the VIE consolidation model. Therefore, if the trust is a VIE, the enterprise applies the VIE consolidation model. We believe the employer is often the primary beneficiary of a rabbi trust that is a VIE (see Question 2.3.120)

2.6 Private company alternative

2.6.10 Private company alternative#

Excerpt from ASC 810-10

Variable Interest Entities

> Accounting Alternative for Entities under Common Control

15-17AC Paragraphs 810-10-15-17AD through 15-17AF, 810-10-50-2AG through 50-2AI, and 810-10-55-205AU through 55-205BF provide guidance for a **private company** electing the accounting alternative for entities under common control in this Subtopic.

15-17AD A **legal entity** need not be evaluated by a private company (reporting entity) under the guidance in the Variable Interest Entities Subsections if all of the following criteria are met:

a. The reporting entity and the legal entity are under common control.
b. The reporting entity and the legal entity are not under common control of a **public business entity**.
c. The legal entity under common control is not a public business entity.
d. The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity when considering the General Subsections of this Topic. The Variable Interest Entities Subsections shall not be applied when making this determination.

Applying this accounting alternative is an accounting policy election. If a private company elects to apply this accounting alternative, it shall apply this alternative to all legal entities if criteria (a) through (d) are met. A reporting entity that elects the accounting alternative and, thus, does not apply the guidance in the Variable Interest Entities Subsections shall continue to apply other accounting guidance (including guidance in the General Subsections of this Subtopic) unless another scope exception from this Topic applies. A reporting entity applying this alternative shall disclose the required information specified in paragraphs 810-10-50-2AG through 50-2AI unless the legal entity is consolidated by the reporting entity through accounting guidance other than VIE guidance.

15-17AE To determine whether the private company (reporting entity) and the legal entity are under common control of a parent solely for the purpose of applying paragraph 810-10-15-17AD(a), the private company shall consider only the parent's direct and indirect voting interest in the private company and the legal entity. In other words, only the guidance in the General Subsections of this Topic shall be considered for determining whether a parent has a direct or indirect controlling financial interest in the private company and the legal entity as required in paragraph 810-10-15-17AD(a). The guidance in the Variable Interest Entities Subsections of this Topic shall not be applied for making this determination. See paragraphs 810-10-55-205AU through 55-205AZ for illustrative guidance.

15-17AF If any of the criteria in paragraph 810-10-15-17AD for applying the accounting alternative cease to be met, a private company shall apply the guidance in the Variable Interest Entities Subsections at the date of change on a prospective basis, except for situations in which a reporting entity becomes a public business entity. When a reporting entity becomes a public business entity, it shall apply the guidance in the Variable Interest Entities Subsections in accordance with Topic 250 on accounting changes and error corrections.

In October 2018, the FASB issued ASU 2018-17, which: [ASU 2018-17]

— replaced the PCC alternative VIE scope exception for common control leasing arrangements with one that applies to all common control arrangements, and
— amended how a decision-maker or service provider determines whether its fee is a variable interest in a VIE when a related party under common control also has a variable interest in the VIE.

The FASB reasoned that expanding the common control alternative was appropriate because private companies under common control often have no explicit or arm's-length contractual arrangements in place unless required by a third party, and this complicates assessing power under the VIE consolidation model. [ASU 2018-17.BC.14]

The new private company accounting alternative applies if: [810-10-15-17-AD]

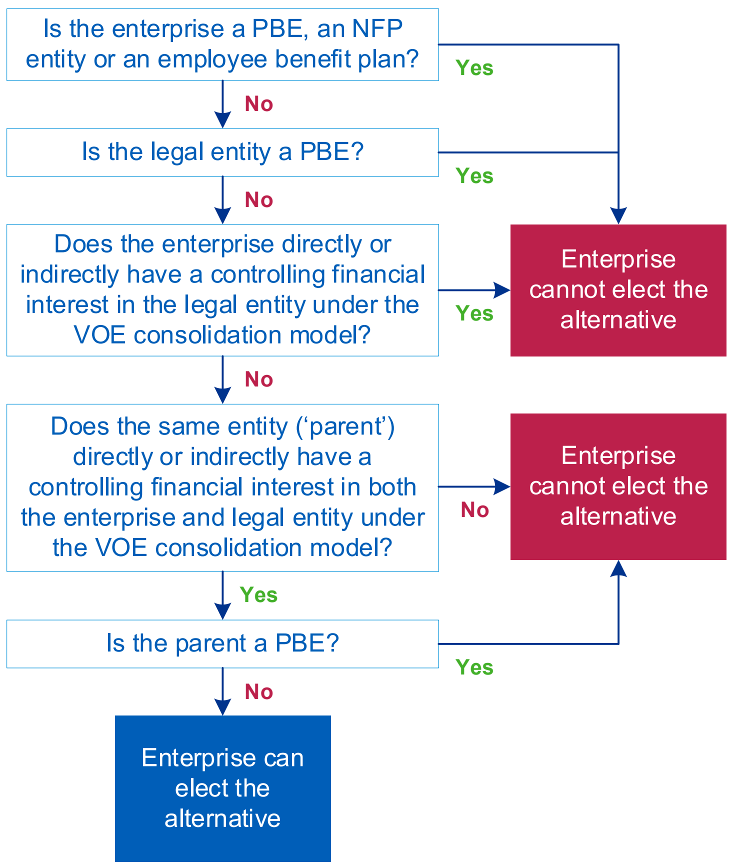
— the common control parent and the legal entity are private companies; and
— the private company does not directly or indirectly have a controlling financial interest in the legal entity under the VOE consolidation guidance.

Question 2.6.10

How does an enterprise determine whether the private company alternative scope exception applies?

Interpretive response: To apply the private company accounting alternative, the enterprise, the legal entity and the common control parent cannot be PBEs. Further, the enterprise cannot directly or indirectly have a controlling financial interest in the legal entity under the VOE consolidation guidance. [810-10-15-17AD]

The following decision tree illustrates how to determine whether a reporting entity can apply the accounting alternative. [810-10-15-17AD]



Question 2.6.20

When is a private company enterprise under common control with a legal entity?

Interpretive response: US GAAP does not define common control, but Topic 810 provides guidance on how to determine whether common control exists when an enterprise evaluates the private company accounting alternative. This guidance on common control is used only for evaluating whether the private company accounting alternative applies. We believe this guidance should not be used when evaluating whether there is common control in other places under Topic 810, such as in the application of the related party guidance (see Question 3.8.230). [810-10-15-17AE]

For a private company enterprise to qualify for the private company accounting alternative, it needs to conclude that the same entity (the 'parent') would have a controlling financial interest in both the private company enterprise and the legal entity being evaluated for consolidation under the VOE consolidation model. [810-10-15-17AE]

The parent does not have a controlling financial interest in one, or both, of the entities using the VOE consolidation model if any of the following conditions exist:

- either the private company enterprise or the legal entity being evaluated for consolidation does not have voting interests – e.g. there are no equity holders or the governing provisions provide no voting rights;
- the majority of the voting interests of either the private company enterprise or the legal entity being evaluated for consolidation are held by another party; or
- the majority of the voting rights of either the private company enterprise or the legal entity being evaluated for consolidation is held by the parent, but its control is restricted by substantive noncontrolling rights.

Because a private company enterprise must establish common control using the VOE consolidation model, whether the parent consolidates one or both of the entities under the VIE consolidation model is irrelevant. In addition, if one or both of the entities is a limited partnership or similar legal entity and the parent is the general partner, the parent generally would not control the limited partnership under the VOE model and therefore could not apply the private company alternative. See also Question 2.6.25 on applying the private company alternative to limited partnerships and similar entities.

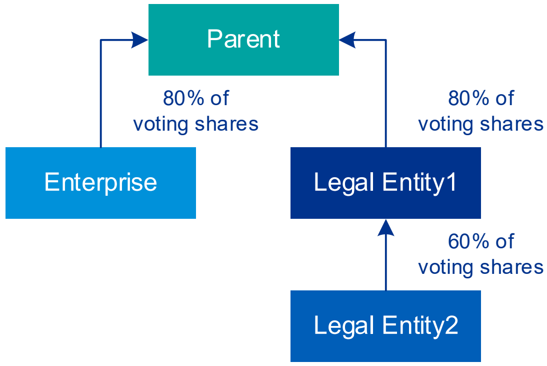
Topic 810 includes two examples of how to apply its common control guidance that are presented in Examples 2.6.10 and 2.6.20, directly below. [810-10-55-205AV – 55-205AX]

Example 2.6.10
Applying the common control analysis – part 1

Background

This example is based on Example 11 in Subtopic 810-10. [810-10-55-205AV – 55-205AX]

The following entities are all private companies.



Evaluation

Based on the VOE consolidation model, Parent has a controlling financial interest in Enterprise and Legal Entity1 because it directly holds a majority of the voting shares in those entities; and nothing indicates that the majority owner does not have control.

Legal Entity1 has a controlling financial interest in Legal Entity2 because it directly holds a majority of the voting shares in this entity; and nothing indicates that the majority owner does not have control.

Parent controls Legal Entity2 through Legal Entity1's controlling financial interest in Legal Entity2. Therefore, for purposes of applying the private company accounting alternative, all four entities are under common control.

However, which entities can apply the private company accounting alternative to their interest in Legal Entity2 depends on whether they have a controlling financial interest in Legal Entity2.

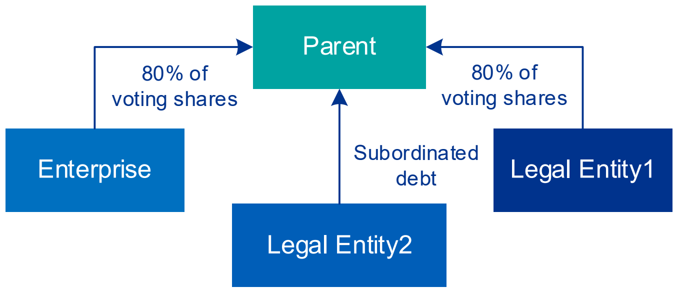
- Enterprise does not have a controlling financial interest in Legal Entity2 and therefore can apply the accounting alternative if the other criteria are met.
- Legal Entity1 cannot apply the accounting alternative to its interest in Legal Entity2 because it has a controlling financial interest in Legal Entity2 under the VOE consolidation model.
- Parent cannot apply the accounting alternative to its interest in Legal Entity2 because it has a controlling financial interest in Legal Entity2 through its controlling financial interest in Legal Entity1 under the VOE consolidation model. This is the case even though Parent's proportionate interest in Legal Entity2 is less than 50% (80% × 60% = 48%).

Example 2.6.20
Applying the common control analysis – part 2

Background

This example is based on Example 12 in Subtopic 810-10. [810-10-55-205AY – 55-205AZ]

The following entities are all private companies.



Evaluation

Based on the VOE consolidation model, Parent has a controlling financial interest in Enterprise and Legal Entity1 because it directly holds a majority of the voting shares; and nothing indicates that the majority owner does not have control. Therefore, these three entities are under common control for purposes of applying the private company accounting alternative.

However, Legal Entity2 is not under common control with Enterprise and Legal Entity1 when considering the private company accounting alternative because Parent does not have a controlling financial interest in Legal Entity2 under the VOE consolidation model.

Whether Legal Entity2 is a VIE (e.g. its total equity at risk may not allow it to finance its activities without additional subordinated financial support), and Parent consolidates it is not relevant to whether the alternative is available to Enterprise or Legal Entity1. This is because Parent does not directly or indirectly hold a majority of Legal Entity2's voting shares. Therefore, Legal Entity2 is not under common control with Enterprise and Legal Entity1 for purposes of the private company accounting alternative.

Therefore, if Enterprise has a potential variable interest in Legal Entity2 (e.g. a guarantee or other financial support), it cannot apply the private company alternative to its interest in Legal Entity2.

Question 2.6.25#

How does a GP evaluate whether it controls a limited partnership when evaluating whether it may apply the private company alternative?

Background: To determine if the private company alternative is available, an enterprise cannot have a controlling financial interest (directly or indirectly) in the legal entity. In making this determination, the enterprise evaluates control under the VOE consolidation model. [810-10-15-17AD(d)]

A GP would not have a controlling financial interest in a limited partnership under the VOE consolidation model because the VOE consolidation model for limited partnerships (or similar entities) generally presumes LP control – i.e. an LP with greater than 50% of kick-out rights is presumed to have a controlling financial interest (see section 5.2.20). This is because limited partners must have substantive kick-out or participating rights for the limited partnership to be a VOE.

Interpretive response: An enterprise that is a GP would evaluate whether it has a controlling financial interest for purposes of applying the private company alternative under the VOE model. Therefore, because a GP would not control the limited partnership under the VOE model, the GP would not be precluded from applying the private company alternative because it has a direct or indirect controlling financial interest in the legal entity. [810-10-15-17AD(d)]

However, as discussed in Question 2.6.20, another criterion to apply the private company alternative is that the enterprise and legal entity are under common control. For purposes of that criterion, the parent would need to have a controlling financial interest in both entities under the VOE model. Therefore, if the parent is the GP of either the enterprise or the legal entity, the parent would not control one or both of those entities under a VOE model and therefore the enterprise would be precluded from applying the private company alternative because the enterprise and legal entity would not be under common control. [810-10-15-17AD(a)]

Question 2.6.30

How is the private company accounting alternative implemented?

Interpretive response: If a private company enterprise elects the accounting alternative, it should: [810-10-15-17AD]

— apply the alternative to all current and future legal entities under common control that meet the criteria;
— continue to apply other consolidation guidance (generally the VOE consolidation guidance) unless another scope exception applies; and
— disclose its involvement with, and exposure to, the legal entity under common control.

If circumstances change such that a private company can no longer apply the accounting alternative, it should generally begin applying the VIE consolidation model in the following manner: [810-10-15-17AF]

Accounting alternative no longer available because:	Apply VIE consolidation model prospectively or retrospectively?
Enterprise becomes a PBE	Retrospectively as a change in accounting principle under Topic 250 (accounting changes)
Any other reason	Prospectively

See chapter 3 in KPMG Handbook, Accounting changes and error corrections, for additional discussion on retrospective and prospective application.

2.6.40 FASB examples

Subtopic 810-10 provides examples of how to apply the private company alternative VIE scope exception.

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Accounting Alternative for Entities under Common Control

>>> Accounting Alternative – Determining Whether Common Control Exists

>>>> Example 11: Accounting Alternative—Common Control Exists

55-205AV Assume the following:

a. Entities A (Parent), B (the reporting entity), C (a legal entity), and E (a legal entity) are all private companies.
b. Entity A holds a majority of the voting shares of Entities B and C.
c. Entity C holds a majority of the voting shares of Entity E.

55-205AW Based on the guidance in paragraph 810-10-25-1, Entity A has a controlling financial interest in Entities B and C because it directly holds a majority of the voting shares in those entities and no circumstances indicate that control does not rest with the majority owner. Entity C also has a controlling financial interest in Entity E because it directly holds a majority of the voting shares in this entity. Therefore, Entity A controls Entity E through Entity C's controlling financial interest in Entity E. For the purposes of applying paragraph 810-10-15-17AD(a), Entities B, C, and E are under common control of Entity A. Assuming the other criteria in paragraph 810-10-15-17AD are met, Entity B (the reporting entity) is eligible to apply the accounting alternative to Entity C and Entity E.

55-205AX If Entity B directly holds a majority of the voting shares of Entity E and no circumstances indicate that control does not rest with the majority owner, Entity B would not be able to apply the accounting alternative to Entity E because paragraph 810-10-15-17AD(d) would not be met. In other words, Entity B would conclude that it holds a controlling financial interest in Entity E when considering only the General Subsections of this Topic (and not the Variable Interest Entities Subsections).

>>>> Example 12: Accounting Alternative—Common Control Does Not Exist

55-205AY Assume the following:

a. Entities A (Parent), B (the reporting entity), C (a legal entity), and E (a legal entity) are all private companies.
b. Entity A holds a majority of the voting shares of Entities B and C.
c. Entities A, B, and C do not hold any voting shares of Entity E (directly or indirectly). However, Entity A has extended subordinated financial support (in the form of debt) to Entity E.

55-205AZ Based on the guidance in paragraph 810-10-25-1, Entity A has a controlling financial interest in Entities B and C because it directly holds a majority of the voting shares in those entities and no circumstances indicate that control does not rest with the majority owner. Therefore, Entities B and C are under common control of Entity A. However, Entity E is not considered to be under common control of Entity A for the purposes of applying paragraph 810-10-15-17AD(a) because Entity A does not directly or indirectly hold a majority of Entity E's voting shares. Moreover, even if Entity E is a VIE and Entity A is its primary beneficiary, Entity E is not considered to be under common control of Entity A for purposes of applying the guidance in paragraph 810-10-15-17AD(a). Accordingly, Entity B (the reporting entity) is precluded from applying the accounting alternative to Entity E.

>>> Application of the Accounting Alternative

55-205BA The following Examples illustrate the application of the guidance in paragraph 810-10-15-17AD on determining whether a reporting entity that is a private company can elect the accounting alternative not to apply VIE guidance to a legal entity under common control:

a. Common control leasing arrangement (Example 13)
b. Car Company (reporting entity) under common control with Engine Company, Tire Company, and Purse Company (Example 14).

>>>> Example 13: Common Control Leasing Arrangement

55-205BB Assume the following:

a. The sole owner (not a public business entity) of Manufacturing Entity (a private company) also is the sole owner of Lessor Entity (a private company).
b. The reporting entity is Manufacturing Entity.
c. Manufacturing Entity leases its manufacturing facility from Lessor Entity.
d. Lessor Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity.
e. Manufacturing Entity pays property taxes on behalf of Lessor Entity and maintains the manufacturing facility.
f. The sole owner of both entities has provided a guarantee of Lessor Entity's mortgage as required by the external lender.
g. Manufacturing Entity has elected to apply the accounting alternative described in paragraph 810-10-15-17AD.

55-205BC Manufacturing Entity meets all the criteria in paragraph 810-10-15-17AD, and, as a result of its elected accounting policy, Manufacturing Entity would apply the accounting alternative to Lessor Entity on the basis of the following:

a. Manufacturing Entity (a private company) and Lessor Entity are under common control.
b. Manufacturing Entity and Lessor Entity are under common control of an individual that is not a public business entity.
c. Lessor Entity is not a public business entity.
d. Manufacturing Entity does not directly or indirectly hold a controlling financial interest in Lessor Entity when considering only the General Subsections of this Topic.

Manufacturing Entity should disclose the required information specified in paragraphs 810-10-50-2AG through 50-2AI unless Lessor Entity is consolidated through accounting guidance other than VIE guidance.

>>>> Example 14: Car Company (Reporting Entity) under Common Control with Engine Company, Tire Company, and Purse Company

55-205BD Assume the following:

a. Reporting entity Car Company (Car Co.), a private company, produces vehicles for sale.
b. Car Co. has elected to apply the accounting alternative described in paragraph 810-10-15-17AD.
c. The sole owner (not a public business entity) of Car Co. also is the sole owner of Engine Company (Engine Co.), Tire Company (Tire Co.), and Purse Company (Purse Co.). Therefore, Car Co., Engine Co., Tire Co., and Purse Co. are considered to be under common control. Only Purse Co. meets the definition of a public business entity.
d. All companies under common control have third-party debt, and each respective company has pledged its assets as collateral for that debt. The third-party debt on each respective company is personally guaranteed by the owner.
e. Engine Co. assumptions:
    1. Engine Co. was created by the owner to vertically integrate the supply chain for Car Co.'s production of vehicles.
    2. Engine Co. produces engines based on Car Co.'s design specifications.
    3. Engine Co. is the sole engine supplier for Car Co., and substantially all of Engine Co.'s production is sold to Car Co.
    4. No other engines on the market could replace the engines supplied by Engine Co.
    5. During 20XX, Car Co. charged Engine Co. $225,684 for management and other services rendered.
    6. During 20XX, Car Co. purchased $9,482,513 in engines from Engine Co.
    7. Engine Co. has an outstanding loan for $600,000 due to Car Co. that is unsecured and accrues interest at 6 percent. This loan is subordinated to all other debt, and there are no specific repayment terms.
    8. Historically, Car Co. has provided funding to Engine Co. at the request of the owner even though there is no existing contractual requirement to do so.
    9. Total book value of Engine Co.'s liabilities is $2,459,127 as of December 31, 20XX.
f. Tire Co. assumptions:
    1. Tire Co. was created by the owner to vertically integrate the supply chain for the Car Co.'s production of vehicles.
    2. Tire Co. sells a majority of its tires to Car Co.
    3. Many substitutes on the market could replace the tires provided by Tire Co.
    4. During 20XX, Car Co. charged Tire Co. $74,568 for management and other services rendered.
    5. During 20XX, Car Co. purchased $3,792,929 of tires from Tire Co.

6. Tire Co. has an outstanding loan for $200,000 due to Car Co. that is unsecured and accrues interest at 6 percent. This loan is subordinated to all other debt, and there are no specific repayment terms.
7. Other than the $200,000 loan, Car Co. has never provided any other additional funding to Tire Co. and is not contractually obligated to do so.
8. Total book value of Tire Co.'s liabilities is $1,250,000 as of December 31, 20XX.

g. Purse Co. assumptions:

1. Purse Co. sells high-end designer purses.
2. No significant transactions or arrangements exist between Purse Co. and the other entities under common control.
3. Car Co. did not provide any management services to Purse Co.
4. Car Co. has never provided any additional funding to Purse Co. and is not contractually obligated to do so.
5. Total book value of Purse Co.'s liabilities is $1,000,000 as of December 31, 20XX.

55-205BE Car Co. meets all the criteria in paragraph 810-10-15-17AD for Engine Co. and Tire Co. and can elect the accounting alternative. As a result of its elected accounting policy, Car Co. would apply the accounting alternative to Engine Co. and Tire Co. on the basis of the following:

a. Car Co. (a private company), Engine Co., and Tire Co. are under common control.
b. Car Co., Engine Co., and Tire Co. are under common control of an individual that is not a public business entity.
c. Neither Engine Co. nor Tire Co. is a public business entity.
d. Car Co. does not directly or indirectly hold a controlling financial interest in Engine Co. or Tire Co. when considering only the General Subsections of this Topic.

Although Purse Co. would not qualify for the accounting alternative because it is a public business entity, Car Co. does not consider Purse Co. to be a legal entity that needs to be assessed for consolidation because Car Co. has no variable interest in Purse Co. Therefore, Car Co. would not provide any disclosures related to Purse Co. under this accounting alternative.

55-205BF Based on the fact pattern described in paragraphs 810-10-55-205BD through 55-205BE, the following disclosures may satisfy the provisions in paragraphs 810-10-50-2AG through 50-2AI:

a. Engine Company, Inc. (Engine Co.): Engine Co. and Car Company, Inc. (the Company) are under common control. Engine Co. was created by the owner to vertically integrate the supply chain for the Company's production of vehicles. The Company's ability to generate profits depends largely on Engine Co. Engine Co. produces engines for the Company's vehicles in accordance with the Company's design specifications for those engines. Substantially all of Engine Co.'s production is sold to the Company, and Engine Co. is the sole supplier of engines to the Company. No other engines on the market could replace the engines supplied by Engine Co. The Company provides Engine Co. with management and other services (including, but not limited to, accounting, billing, and administrative duties) for which it charged a management fee of $225,684 in 20XX. The Company purchased $9,482,513 of engines during 20XX from Engine Co. Engine Co. has an outstanding loan in the amount of $600,000 due to the Company that is unsecured and accrues interest at 6 percent. The loan is subordinated to all other debt, and no specific repayment terms exist.

b. Tire Company, Inc. (Tire Co.): Tire Co. and the Company are under common control. Tire Co. was created by the owner to vertically integrate the supply chain for the Company's production of vehicles. Tire Co. produces tires for the Company's vehicles and sells a majority of those tires to the Company. The Company provides no design specifications for the tires, and many substitutes on the market could replace the tires that Tire Co. provides. The Company provides Tire Co. with management and other services (including, but not limited to, accounting, billing, and administrative duties) for which it charged a management fee of $74,568 in 20XX. Car Co. purchased $3,792,929 of tires during 20XX from Tire Co. Tire Co. has an outstanding loan in the amount of $200,000 due to the Company that is unsecured and accrues interest at 6 percent. The loan is subordinated to all other debt, and no specific repayment terms exist.

c. Both Engine Co. and Tire Co. have third-party debt, and both companies have their assets pledged as collateral for that debt. The owner of the Company, Engine Co., and Tire Co. has personally guaranteed the third-party debt of the Company, Engine Co., and Tire Co.

d. In addition to the $600,000 loan, the Company historically has been required to provide funds to Engine Co. at the request of the common owner. The Company believes that its maximum financial exposure to loss related to Engine Co. could equal all of Engine Co.'s liabilities. The book value of Engine Co.'s liabilities is $2,459,127 as of December 31, 20XX.

e. Other than the $200,000 loan, the Company has never provided any other additional funding to Tire Co. and is not contractually obligated to do so. The Company believes that its maximum financial exposure related to Tire Co. is limited to the $200,000 loan outstanding and any accrued interest as of December 31, 20XX.

3. Is the interest a variable interest?

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

Examples

Examples

3.1 How the standard works

An enterprise evaluates whether a legal entity is a VIE only after it determines:

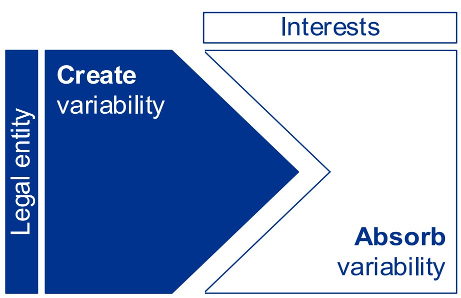
- the legal entity is in the scope of the VIE Subsections of Subtopic 810-10 (see chapter 2), and
- it holds a variable interest in the legal entity based on an analysis of the legal entity's purpose and design.

A variable interest is an interest through which a party involved with a legal entity shares in the entity's economic risks and rewards – i.e. the entity's variability. Specifically, a variable interest absorbs some of the entity's expected losses, expected residual returns or both. Expected losses and expected residual returns are not:

- the anticipated amount of the legal entity's losses or profit; or
- the expected variability of the net income or loss.

Expected losses are the negative variability in the fair value of the VIE's net assets (excluding variable interests). Expected residual returns are the positive variability in the fair value of the VIE's net assets (excluding variable interests). Fair value and variability are generally determined using expected cash flows. For additional discussion on determining these amounts, see chapter 10.

Only absorbers of variability are considered variable interests – not interests that create a legal entity's variability. The relationship between a legal entity's design, its creators of variability, and its absorbers of variability can be illustrated as follows.



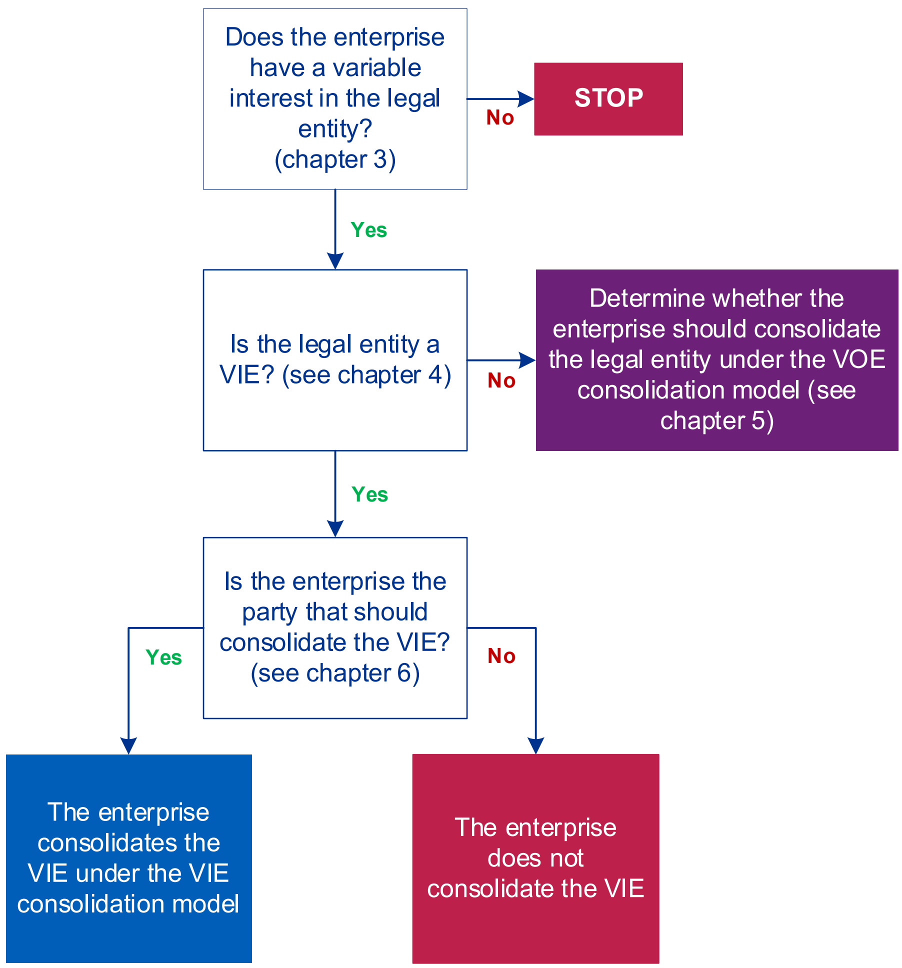
To identify whether it has a variable interest in a legal entity, an enterprise performs the following.

Identify risks created by the legal entity	Apply the by-design approach to identify the risks the legal entity was designed to create and distribute to its interest holders.	Section 3.3
Identify interests in the legal entity	Identify all of the legal entity's interests. — **Explicit interests.** Interests based on contracts directly with the legal entity. — **Implicit interests.** Interests derived indirectly through contractual or noncontractual arrangements with the legal entity, direct variable interest holders in the legal entity or related parties.	Sections 3.4 and 3.5

Determine which interests absorb the risks	Determine whether any of the interests identified absorb any of the risks identified – only those interests are considered variable interests.

Special consideration is necessary for interests in only specified assets (section 3.6) or segregated operations inside the legal entity (potential silos, section 3.7). Fees paid to a decision-maker (section 3.8) also require special consideration in determining whether they represent variable interests.

The following diagram provides an overview of the steps taken after determining whether the enterprise has a variable interest in the legal entity.



3.2 Overview of variable interests

Excerpt from ASC 810-10

20 Glossary

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.

Excerpt from ASC 810-10

> Overall Guidance

15-13A For purposes of applying the Variable Interest Entities Subsections, only substantive terms, transactions, and arrangements, whether contractual or noncontractual, shall be considered. Any term, transaction, or arrangement shall be disregarded when applying the provisions of the Variable Interest Entities Subsections if the term, transaction, or arrangement does not have a substantive effect on any of the following:

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

15-13B Judgment, based on consideration of all the facts and circumstances, is needed to distinguish substantive terms, transactions, and arrangements from nonsubstantive terms, transactions, and arrangements. The purpose and design of legal entities shall be considered when performing this assessment.

A 'variable interest' is an interest through which an enterprise involved with a legal entity shares in that entity's economic risks and rewards – i.e. the entity's variability. Variable interests can be contractual, ownership or other monetary interests in a VIE. [810-10 Glossary]

Not all interests that share (i.e. absorb) a legal entity's variability are variable interests. Only those interests that share in the variability the legal entity was designed to create and distribute are variable interests. Such risks are identified through the 'by-design' approach (see section 3.3).

An enterprise should consider only substantive terms, transactions or arrangements when evaluating whether it holds a variable interest in an entity. Therefore, when identifying potential variable interests, it is important to use judgment in determining whether the terms are substantive in the context of the purpose and design of the legal entity. This substance requirement applies to all aspects of VIE analyses. [810-10-15-13A – 15-13B]

Question 3.2.10

Why does an enterprise evaluate whether it has a variable interest in a legal entity before it determines whether the entity is a VIE or VOE?

Interpretive response: Typically, an enterprise identifies a legal entity's variable interests **before** it evaluates whether the entity is a VIE or a VOE because:

— if it does not have a variable interest, it cannot consolidate the entity regardless of whether it is a VIE or a VOE; and

— whether certain arrangements are variable interests may affect whether the entity is ultimately a VIE or a VOE – e.g. an arrangement that conveys decision-making authority to a member outside the equity-at-risk group (see sections 3.8 and 4.3).

Although the variable interest definition refers to an interest in a VIE, an enterprise can have a variable interest in a VOE.

Variable interest in a VIE

A variable interest in a VIE can take many forms and each has the potential to convey a controlling financial interest in a VIE.

Variable interest in a VOE

Variable interests in a VOE are more limited because by definition the equity-at-risk group in a VOE:

— holds a sufficient amount of equity to allow the entity to finance its activities;
— is not protected from absorbing the entity's expected losses; and
— is not capped from receiving the entity's expected residual returns.

As a result, there are limited interests that exist outside the equity-at-risk group that absorb the variability that a VOE was designed to create and distribute to its interest holders. Further, those limited interests are even less likely to have a controlling financial interest in the VOE. This is true because by definition the equity-at-risk group in a VOE has the power through its voting rights to direct the activities that most significantly impact the entity's economic performance.

Question 3.2.20

What are some examples of potential variable interests?

Interpretive response: Variable interests are not limited to a predefined list of contractual arrangements. Instead, they are broadly defined as contractual, ownership or other economic, monetary or financial interests in an entity that change with changes in the fair value of the entity's net assets (excluding the variable interests). Variable interests can be explicit (see section 3.4) or implicit (see section 3.5). [810-10-55-20]

Examples of potential variable interests include the following (not exhaustive):

— equity and debt instruments (see section 3.4.10);
— beneficial interests (see section 3.4.10);
— guarantees (see section 3.4.30);
— put and call options (see section 3.4.20);
— forward contracts and other derivative instruments (see section 3.4.20);
— management and other service contracts (see section 3.8);
— assets of an entity (see section 3.4.30);
— leases (see section 3.4.40);
— residual value guarantees (see section 3.4.40); and
— franchise arrangements (see section 4.4.20).

The above interests are variable interests only if they involve substantive terms, transactions or arrangements (see Question 3.2.30).

Question 3.2.30

What are 'substantive' terms, transactions and arrangements?

Interpretive response: When identifying variable interests, an enterprise considers only substantive terms, transactions and arrangements. 'Substantive' terms, transactions and arrangements are designed to achieve specific business objectives, not a particular accounting outcome. Such terms affect the economic considerations of the parties involved.

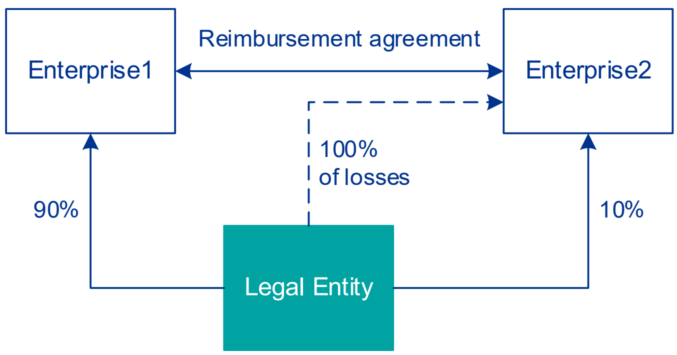
Professional judgment is required to determine whether terms, transactions and arrangements are substantive when an enterprise becomes involved with a legal entity and when changes to the arrangements are made. In making the assessment, it may be helpful for the enterprise to compare the terms, transactions and arrangements to its involvement with similar entities and under similar circumstances. Terms, transactions, and arrangements with a legal entity that are consistent with the enterprise's usual involvement may indicate that those items are substantive. After initial consideration, changes to existing arrangements generally are substantive only when they result in proportionate changes to the economic positions of the parties involved.

The FASB included the substantive condition to indicate the importance of a substance-over-form approach. The goal was to avoid situations in which the form of a legal entity (or an enterprise) might indicate that it is not a VIE (or primary beneficiary) when the substance of the arrangement indicates otherwise. The FASB did not intend for this guidance to imply that nonsubstantive terms should be considered in other areas of US GAAP. [FAS 167.A5]

Example 3.2.10
Nonsubstantive rights

Background

Legal Entity has two investors, Enterprise1 and Enterprise2.



Enterprise1 holds 90% of the equity in Legal Entity and Enterprise2 holds the remaining 10%. Legal Entity's governing documents state that Enterprise1 and Enterprise2 share in Legal Entity's results of operations in proportion to their ownership percentages.

Enterprise2 enters into a separate arrangement with Legal Entity to absorb Enterprise1's share (90%) of Legal Entity's losses in exchange for $1. At the same time, Enterprise2 enters into an agreement with Enterprise1 whereby Enterprise1 will reimburse Enterprise2 for the losses it absorbs on behalf of Enterprise1 – i.e. losses in excess of Enterprise2's 10% share based on its ownership percentage. No other entities are involved with Legal Entity.

Evaluation

The arrangement between Legal Entity and Enterprise2 is nonsubstantive, because none of the risk of loss transfers to Enterprise2 as a result. Therefore, it has no impact on the absorbers of Legal Entity's risks.

As a result, when evaluating the Legal Entity and identifying its potential variable interest holders, this arrangement would be disregarded. The variable interests in Legal Entity are the equity positions held by Enterprise1 and Enterprise2.

Question 3.5.10 discusses how a contract outside a legal entity can create an implicit variable interest and Question 3.3.10 discusses the requirement that a variable interest absorb variability that the legal entity was designed to create and distribute to its interest holders.

Example 3.2.20

Restructuring, nonsubstantive rights: commercial paper conduit

Background

In Year 1, Sponsor and Sellers form a VIE to serve as a multi-seller commercial paper conduit (Conduit SPE). Sponsor is Conduit SPE's administrator.

As Sellers transfer trade receivables to Conduit SPE, Conduit SPE issues commercial paper. The commercial paper has various durations and is issued on a rolling basis to fund the ongoing purchases of receivables from Sellers.

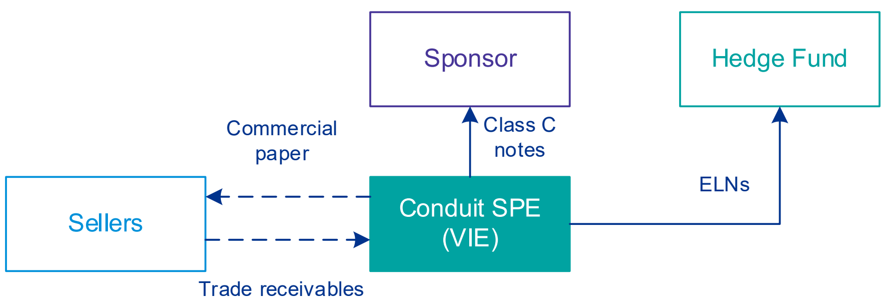
In addition to the commercial paper, Conduit SPE issues:

— a small amount of long-term subordinated Class C notes to Sponsor; and
— expected-loss notes (ELNs) to a hedge fund domiciled in Bermuda.

The Class C notes are senior only to the ELNs. The ELNs are designed to absorb a majority of Conduit SPE's expected losses.

Sponsor consolidates Conduit SPE because it has both of the following (see chapter 6):

— the power to direct the activities that most significantly affect the VIE's economic performance through its role as the administrator; and
— the obligation to absorb variability that could potentially be significant to the VIE.



In Year 3, Sponsor restructures the legal agreements. Under the amendments, Hedge Fund (as ELN holder) has the unilateral ability to remove Sponsor without cause.

At the time of the restructuring there were no corresponding changes in the economic arrangements between Conduit SPE's variable interest holders.

Evaluation

We believe Hedge Fund's unilateral kick-out right would be considered nonsubstantive and therefore disregarded when applying Subtopic 810-10 based on the following.

— Hedge Fund had limited rights before the restructuring and did not provide consideration to Sponsor that was commensurate with the kick-out rights it received.

— Hedge Fund would not be expected to have adequate expertise to administer Conduit SPE. This suggests that there is a significant disincentive to exercise the kick-out right (see chapter 6).

— There is no specific business objective for Sponsor to provide Hedge Fund the kick-out right – i.e. it appears the kick-out right was intended only to achieve a particular accounting result.

We also believe that if Conduit SPE was originally formed in Year 3 with the same unilateral kick-out right, the conclusion would be the same – i.e. the kick-out right would be considered nonsubstantive and therefore disregarded when applying Subtopic 810-10.

3.3 The by-design approach

Excerpt from ASC 810-10

Variable Interest Entities

> Determining the Variability to Be Considered

25-21 The variability that is considered in applying the Variable Interest Entities Subsections affects the determination of all of the following:

a. Whether the legal entity is a VIE
b. Which interests are variable interests in the legal entity
c. Which party, if any, is the **primary beneficiary** of the VIE.

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

25-22 The variability to be considered in applying the Variable Interest Entities Subsections shall be based on an analysis of the design of the legal entity as outlined in the following steps:

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

25-23 For purposes of paragraphs 810-10-25-21 through 25-36, interest holders include all potential variable interest holders (including contractual, ownership, or other pecuniary interests in the legal entity). After determining the variability to consider, the reporting entity can determine which interests are designed to absorb that variability. The cash flow and fair value are methods that can be used to measure the amount of variability (that is, expected losses and expected residual returns) of a legal entity. However, a method that is used to measure the amount of variability does not provide an appropriate basis for determining which variability should be considered in applying the Variable Interest Entities Subsections.

25-24 The risks to be considered in Step 1 that cause variability include, but are not limited to, the following:

a. Credit risk
b. Interest rate risk (including prepayment risk)
c. Foreign currency exchange risk
d. Commodity price risk
e. Equity price risk
f. Operations risk.

Excerpt from ASC 810-10

> Determining the Variability to Be Considered

25-25 In determining the purpose for which the legal entity was created and the variability the legal entity was designed to create and pass along to its interest holders in Step 2, all relevant facts and circumstances shall be considered, including, but not limited to, the following factors:

a. The activities of the legal entity
b. The terms of the contracts the legal entity has entered into
c. The nature of the legal entity's interests issued
d. How the legal entity's interests were negotiated with or marketed to potential investors
e. Which parties participated significantly in the design or redesign of the legal entity.

25-26 Typically, assets and operations of the legal entity create the legal entity's variability (and thus, are not variable interests), and liabilities and equity interests absorb that variability (and thus, are variable interests). Other contracts or arrangements may appear to both create and absorb variability because at times they may represent assets of the legal entity and at other times liabilities (either recorded or unrecorded). The role of a contract or arrangement in the design of the legal entity, regardless of its legal form or accounting classification, shall dictate whether that interest should be treated as creating variability for the entity or absorbing variability.

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

25-28 Example 3 (see paragraph 810-10-55-55) is intended to demonstrate how to apply the provisions of this guidance on determining the variability to be considered, including whether arrangements (such as derivative instruments or guarantees of value) create variability (and are therefore not variable interests) or absorb variability (and are therefore variable interests).

25-29 A qualitative analysis of the design of the legal entity, as performed in accordance with the guidance in the Variable Interest Entities Subsections, will often be conclusive in determining the variability to consider in applying the guidance in the Variable Interest Entities Subsections, determining which interests are variable interests, and ultimately determining which variable interest holder, if any, is the primary beneficiary.

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

55-17 The identification of variable interests requires an economic analysis of the rights and obligations of a legal entity's assets, liabilities, equity, and other contracts. Variable interests are contractual, ownership, or other pecuniary interests in a legal entity that change with changes in the **fair value** of the legal entity's net assets exclusive of variable interests. The Variable Interest Entities Subsections use the terms **expected losses and expected residual returns** to describe the **expected variability** in the fair value of a legal entity's net assets exclusive of variable interests.

55-18 For a legal entity that is not a VIE (sometimes called a voting interest entity), all of the legal entity’s assets, liabilities, and other contracts are deemed to create variability, and the equity investment is deemed to be sufficient to absorb the expected amount of that variability. In contrast, VIEs are designed so that some of the entity’s assets, liabilities, and other contracts create variability and some of the entity’s assets, liabilities, and other contracts (as well as its equity at risk) absorb or receive that variability.

55-19 The identification of variable interests involves determining which assets, liabilities, or contracts create the legal entity's variability and which assets, liabilities, equity, and other contracts absorb or receive that variability. The latter are the legal entity's variable interests. The labeling of an item as an asset, liability, equity, or as a contractual arrangement does not determine whether that item is a variable interest. It is the role of the item—to absorb or receive the legal entity's variability—that distinguishes a variable interest. That role, in turn, often depends on the design of the legal entity.

55-20 Paragraphs 810-10-55-16 through 55-41 describe examples of variable interests in VIEs subject to the Variable Interest Entities Subsections. These paragraphs are not intended to provide a complete list of all possible variable interests. In addition, the descriptions are not intended to be exhaustive of the possible roles, and the possible variability, of the assets, liabilities, equity, and other contracts. Actual instruments may play different roles and be more or less variable than the examples discussed. Finally, these paragraphs do not analyze the relative significance of different variable interests, because the relative significance of a variable interest will be determined by the design of the VIE. The identification and analysis of variable interests must be based on all of the facts and circumstances of each entity.

55-21 Paragraphs 810-10-55-16 through 55-41 also do not discuss whether the variable interest is a variable interest in a specified asset of a VIE or in the VIE as a whole. Guidance for making that determination is provided in paragraphs 810-10-25-55 through 25-56. Paragraphs 810-10-25-57 through 25-59 provide guidance for when a VIE shall be separated with each part evaluated to determine if it has a primary beneficiary.

As discussed in section 3.2, a variable interest is an interest through which a party involved with a legal entity shares in its economic risks and rewards – i.e. the entity's variability. Specifically, a variable interest absorbs some of the entity's expected losses, expected residual returns or both.

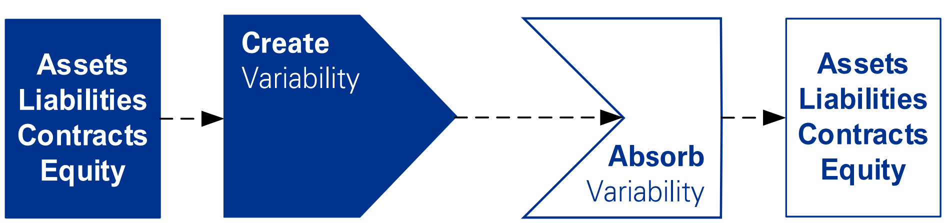
Question 3.3.10

What is the by-design approach?

Interpretive response: The first step for determining if an interest is a variable interest is to identify the variability that the legal entity was designed to create and distribute to its interest holders. This is done by applying the by-design approach, which has two steps. [810-10-25-22]

Step 1	Analyze the nature of the legal entity's risks
Step 2	Determine the legal entity's purpose and the variability it is designed to create and distribute to its interest holders

After an enterprise identifies the legal entity's variability using the by-design approach, it evaluates if the interest that it holds absorbs or creates the variability. If the interest absorbs variability that the legal entity was designed to create and distribute to its interest holders, the interest is a variable interest in the entity. [810-10-25-21, 25-23]



An interest is not a variable interest if it: [810-10-25-21 – 25-36]

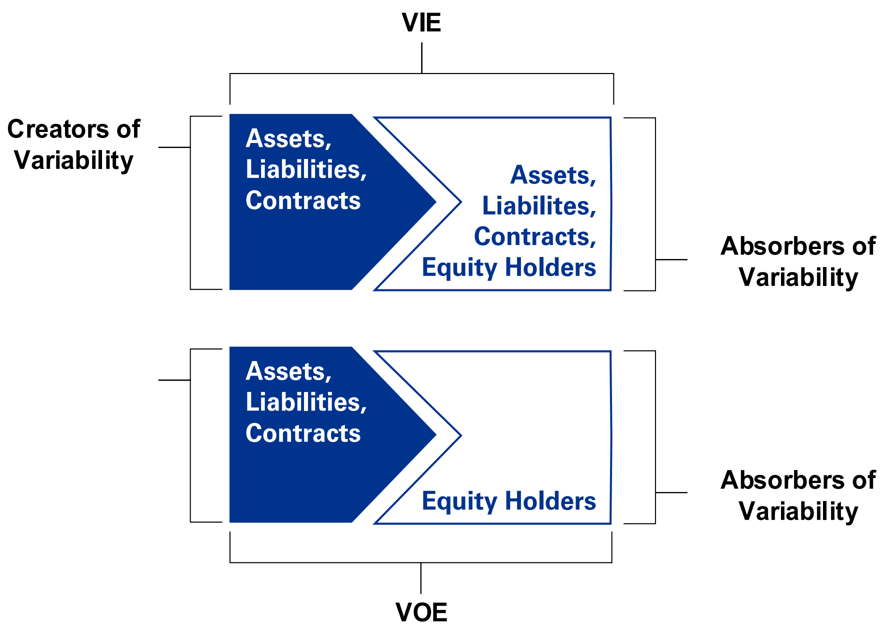
— creates variability; or
— absorbs variability that the legal entity was not designed to create and distribute to its interest holders.

Further, there are situations in which an interest may represent an interest in specified assets (section 3.6) or a variable interest in a silo VIE (section 3.7). Those interests are **not** variable interests in the legal entity itself. [810-10-55-21]

Question 3.3.20
How do variable interests in a VIE differ from variable interests in a VOE?

Interpretive response: A key difference between a VIE and a VOE is the nature of the interests that absorb the legal entity's variability. In a VOE, the equity is always sufficient to allow the holders of that equity to absorb the entity's expected losses (see section 4.3). As a result, there are limited interests outside the equity-at-risk group that absorb the expected losses or receive the expected benefits that a VOE was designed to create and distribute to its interest holders (see Question 3.2.10).

In a VIE, there is often a much wider population of absorbers; it includes equity holders but may also include other interests – e.g. holders of the entity's liabilities, derivative counterparties or service providers. [810-10-55-18]



Question 3.3.30
What risks does an enterprise consider in Step 1 of the by-design approach?

Interpretive response: Step 1 of the by-design approach is to identify the nature of the legal entity's risks. Examples of risks include the following (not exhaustive). [810-10-25-24]

Risk	Example
Credit risk	The risk that the entity will default on all or part of its obligations.

Risk	Example
Interest rate risk	The risk that the interest payments on a floating-rate financial instrument will vary. The risk that the fair value of a fixed-rate financial instrument will change based on interest rate fluctuations.
Foreign currency exchange risk	The risk that the cash flows from a fixed-price sales contract denominated in a foreign currency will fluctuate because of changes in the rate at which the foreign currency is converted into the legal entity's functional currency.
Price risk	The risk of fluctuations in the prices of assets – e.g. real estate, equity instruments or commodities used in producing inventories.
Operations risk	The risk that the legal entity's operating costs (e.g. labor costs) will fluctuate.

Question 3.3.40

What factors are considered in identifying a legal entity's variability in Step 2 of the by-design approach?

Interpretive response: The objective of Step 2 of the by-design approach is to reduce the list of the risks identified in Step 1 (see Question 3.3.30) to only those that the legal entity was designed to create and pass along to its interest holders.

An enterprise considers all relevant facts and circumstances when performing Step 2, including, but not limited to the following: [810-10-25-25, 25-27]

— the nature of the legal entity's activities;
— the terms of the legal entity's contracts;
— the nature of the interests the legal entity has issued, including its assets, liabilities and equity;
— how the interests the legal entity has issued were marketed to and negotiated with potential investors; and
— which parties participated significantly in the legal entity's design or redesign.

An enterprise generally will be able to identify a legal entity's variability by performing a qualitative analysis of the rights and obligations of the entity's assets, liabilities, equity and other contracts. [810-10-25-29, 55-17]

Question 3.3.50

Can an enterprise net the effects of a legal entity's contracts to determine which risks it is designed to create and distribute in Step 2 of the by-design approach?

Interpretive response: Generally, no. We believe each arrangement with a legal entity generally should be separately evaluated to determine if it is a creator or an absorber of variability – even if some arrangements may partially or fully offset each other.

However, we do not believe an enterprise should identify a risk in Step 2 if it both creates the variability and absorbs it. A single interest holder in that situation would conclude it does not have a variable interest in the legal entity. This is because a variable interest holder cannot absorb variability that it alone creates (see Question 3.4.20).

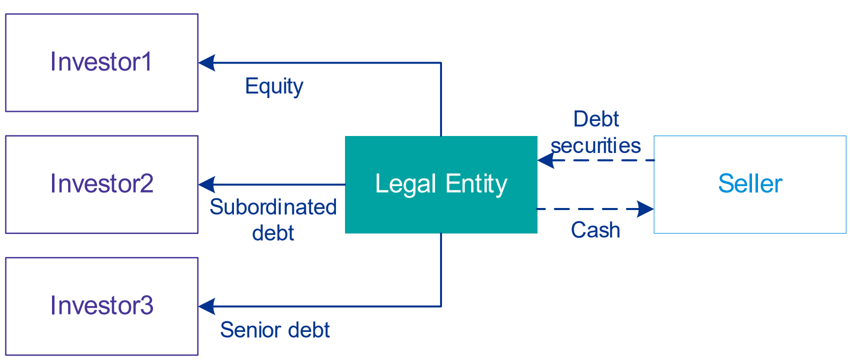
Example 3.3.10

Offsetting interests when applying the by design approach

Background

At formation, Legal Entity issues equity to Investor1, subordinated debt to Investor2 and senior debt to Investor3. Legal Entity uses the cash received to purchase debt securities from Seller.

The equity and subordinated debt, in total, are expected to be sufficient to absorb the credit risk expected to arise from the debt securities.



Evaluation

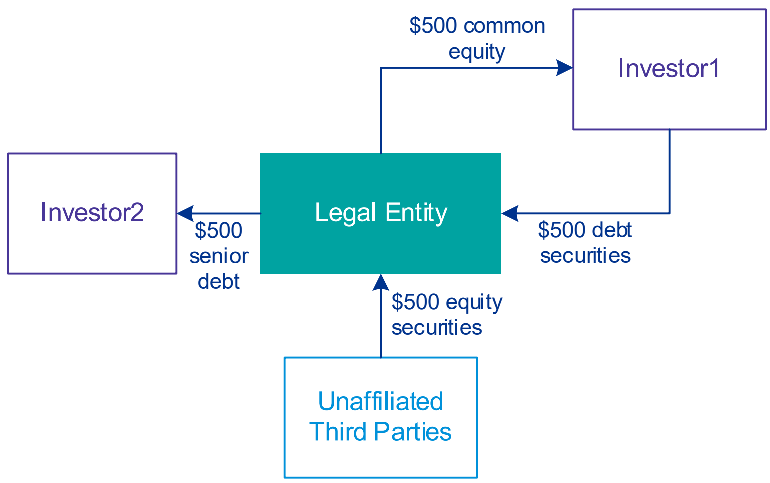
Investor1, Investor2 and Investor3 are the absorbers of Legal Entity's variability and the debt securities are creators of the variability.

In this example, the nature of Legal Entity's assets, liabilities and equity suggests that Legal Entity was designed to distribute credit risk to the interest holders as a group – including the senior debt interests. This is notwithstanding that the combined equity and subordinated debt interests are expected to be sufficient to absorb that variability.

Example 3.3.20
A party that absorbs the variability that it creates

Background

At formation, Legal Entity issues $500 of common equity to Investor1 and $500 of senior debt to Investor2. Legal Entity uses the cash received to purchase a $500 debt security issued by Investor1 and $500 of equity securities issued by unaffiliated third parties.



Evaluation

In this example, Legal Entity likely is designed to create and distribute to its interest holders the risks associated with the equity securities issued by the unaffiliated third parties. Investor1 is both a creator of variability (through its obligation to Legal Entity) and an absorber (through its equity interest). In this example, it is appropriate for Investor1 to exclude the risks associated with the $500 of debt that it owes to Legal Entity when evaluating its exposure to Legal Entity's variability. Evaluating these situations requires professional judgment and all relevant facts and circumstances should be carefully evaluated.

Question 3.3.60
How does an enterprise determine if it absorbs the variability it identified in Step 2 of the by-design approach?

Interpretive response: After an enterprise identifies the legal entity's variability using the by-design approach, it evaluates if the interest that it holds absorbs or creates that variability (see sections 3.4 – 3.8).

If the interest absorbs variability that the legal entity was designed to create and distribute to its interest holders, the interest is a variable interest in the entity. However, there is an exception if the enterprise's interest creates the variability it absorbs (see Question 3.3.50). [810-10-25-26, 55-19]

Whether an interest absorbs variability depends primarily on two factors:

— the terms of the interest (see section 3.3.10); and
— the degree of subordination in the structure (see section 3.3.20).

This evaluation does not depend on the interest's legal form (see section 3.3.10).

The above factors apply in general when evaluating an interest. There is also specific guidance on how to evaluate interests that involve interest rate risk (see section 3.3.30) and derivative instruments (see section 3.3.40). [810-10-25-30 – 25-36]

Example 3.3.30

Applying the by-design approach to a Domestic International Sales Corporation (DISC)

Background

A Domestic International Sales Corporation (DISC) is a US corporation that has elected DISC status and meets certain other largely perfunctory requirements. A DISC is not subject to US federal income tax.

A DISC contracts with a producer (or reseller) of US-made goods to provide services for a fee that is determined under formulas and rules defined in the law and regulations. Under these regulations, the fee is deductible by the producer and results in a net profit to the DISC, which is not subject to federal income tax. [IRC §991, §997]

The DISC then distributes the profit to its shareholders, who are taxed on the income as a dividend. If the shareholders are US resident individuals or others eligible for the reduced tax rate on dividends, the tax paid on the income passed through the DISC is less than it would have been if the producer had not used the DISC.

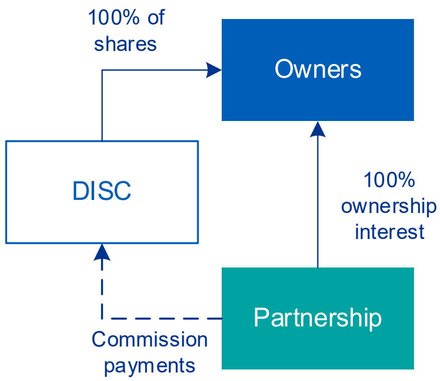
The legal pricing rules between the DISC and the producer are independent of the transfer pricing rules normally applicable to transactions between related parties. As a result, the DISC does not need to (1) economically contribute or (2) have business substance.

Scenario

Partnership enters into a commission agreement with DISC. DISC has been organized to promote exported products of Partnership.

DISC charges Partnership a commission equal to 50% of net export income for promoting Partnership's exported products.

Partnership's partners (Owners) are also the DISC's shareholders. Partnership and DISC are related parties.



Evaluation

Partnership does not have an explicit variable interest in DISC because DISC was designed to create and distribute the price risk created by the commission contract with Partnership and the tax risk associated with the structure. Partnership's commission contract is a creator (instead of an absorber of variability) and Partnership has no other relationship with DISC.

In addition, Partnership does not have an implicit variable interest in DISC (see section 3.5) because Partnership is not entitled to receive benefits from, or obligated to absorb losses of, DISC. If the IRS challenges payments made to DISC, the increased tax burden would be borne by DISC's individual shareholders and not the Partnership itself.

Further, DISC has no debt or other obligations and there is no foreseeable circumstance in which Partnership could be called upon to support DISC.

3.3.10 Terms of the interest

Excerpt from ASC 810-10

Variable Interest Entities

> Determining the Variability to Be Considered

>> Terms of Interests Issued

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

The by-design approach requires consideration of more than just an instrument's legal form or accounting classification when determining whether an interest is a variable interest. If the terms of an interest transfer some of the risks that an entity was designed to create to the interest holder(s), it may be a variable interest. Therefore, a variable interest may not be a recognized asset, liability or equity interest for US GAAP purposes. [810-10-25-31]

Question 3.3.70

Does the legal form of a contract dictate what, if any, risk it creates or absorbs?

Interpretive response: A variable interest is any contract or arrangement that transfers to the counterparty some of the variability that the legal entity was designed to create and distribute to its interest holders. This means the contract or arrangement must transfer variability. However, the interest's legal form and accounting classification are not necessarily determinative.

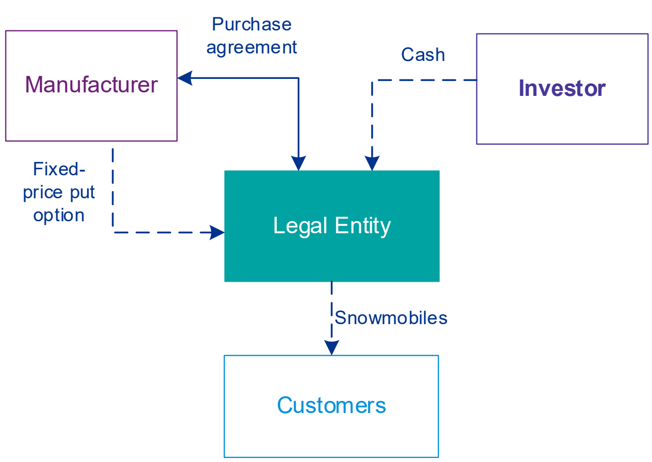
For example, an enterprise's variable interest may take the form of a service contract with the legal entity that the legal entity does not recognize in its financial statements. The fact that the legal entity does not recognize the service contract under US GAAP does not affect the by-design approach. This approach simply considers what risks the legal entity is exposed to (Step 1) and which of those risks it was designed to create and distribute to its interest holders (Step 2). [810-10-25-26, 25-31]

Example 3.3.40

Transfer of price risk

Background

Manufacturer and Investor form Legal Entity to sell snowmobiles to customers in Saskatchewan. At formation, Investor contributes cash and Legal Entity enters into an agreement to purchase snowmobiles at a fixed price from Manufacturer. Under the agreement, Legal Entity may return unsold snowmobiles to Manufacturer at any time for the price paid. Manufacturer has no other involvement with Legal Entity.



Evaluation

Legal Entity is designed to create and distribute to its interest holders inventory price risk. Manufacturer absorbs that risk through the option it has written, which allows Legal Entity to put the unsold snowmobiles back to Manufacturer for a fixed price. As a result of this option, Manufacturer has a variable interest in Legal Entity.

Note: Investor may also have a variable interest; however, this example focuses on the Manufacturer absorbing inventory price risk.

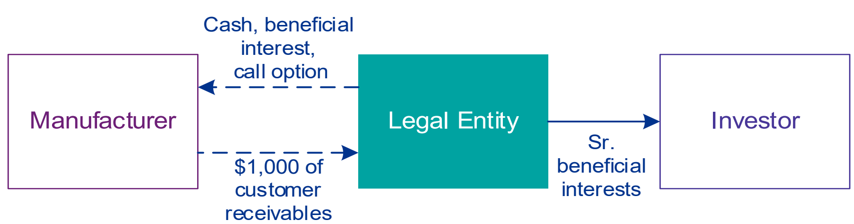
Example 3.3.50

Transfer of receivables to an SPE

Background

Manufacturer transfers $1,000 of customer receivables to Legal Entity, an SPE financing vehicle. At formation the following transactions occur.

— Investor contributes $800 to Legal Entity in exchange for senior beneficial interests.
— Manufacturer transfers $1,000 of receivables to Legal Entity in exchange for $800 in cash and $200 in subordinated beneficial interests.
— Manufacturer also receives a fixed-price call option on the receivables transferred.



Because of the fixed-price call option, the transaction is accounted for as a financing (instead of a sale) under Topic 860 (transfers and servicing). As a result, Legal Entity recognizes as an asset a receivable from Manufacturer (instead of customer receivables).

Evaluation

In this example, Legal Entity was designed to create and distribute to its interest holders the credit risk associated with the customer receivables. Although for US GAAP purposes Legal Entity recognizes a receivable from Manufacturer, it is not exposed to Manufacturer's credit risk. Manufacturer has a variable interest in Legal Entity because it absorbs this credit risk through its written call option on the customer receivables.

Note: Investor may also have a variable interest; however, this example focuses on Manufacturer absorbing credit risk.

3.3.20 Subordination

Excerpt from ASC 810-10

Variable Interest Entities

> Determining the Variability to Be Considered

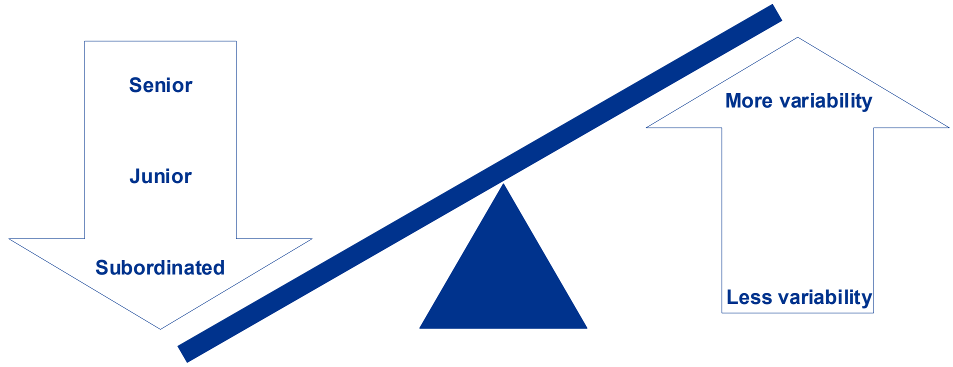
>> Subordination

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

A legal entity is often formed with a capital structure that includes both senior and subordinated interests.

When there is **substantive** subordination in a legal entity's capital structure, the variability absorbed by the subordinated interests is typically identified as the variability that the legal entity was designed to create and distribute to its interest holders. [810-10-25-32]

When evaluating whether subordination is substantive, an enterprise considers the degree to which the subordinated interest absorbs the legal entity's variability. A subordinated interest generally absorbs a greater proportion of a legal entity's total variability than a senior interest. For example, a holder of senior debt instruments with fixed interest rates normally absorbs little variability if there is a substantive level of subordinated interests to absorb the legal entity's expected variability.



Question 3.3.80

What factors are considered when evaluating whether subordination is substantive?

Interpretive response: When determining whether a legal entity's subordination is substantive, the factors an enterprise considers include the following (not exhaustive). We believe an enterprise considers all relevant factors when making this determination and can often conclude using a qualitative analysis.

Factors	Description
Variability expected to be absorbed by a legal entity's interests	If a legal entity's senior interests are expected to absorb little of the entity's total variability, it is likely that the legal entity's subordination is substantive.
Credit ratings of the legal entity's interests	Wide dispersion of a legal entity's debt credit ratings is an indicator that subordination is substantive. For example, for a legal entity that has five tranches of debt, subordination is more likely to be substantive if there are five different credit ratings across those tranches than if there are only two credit ratings. If the subordination is substantive, the variability absorbed by the most subordinated interests is likely the variability that the legal entity was designed to create and distribute to its interest holders.
Magnitude of the entity's subordinate interests	Legal entities with higher percentages of equity to debt and subordinated debt to senior debt may have a more substantive level of subordination.
Interest rates and yields on a legal entity's interests	A legal entity with a subordinated capital structure may have several tranches of debt outstanding. Generally, the senior tranches will have a lower interest rate than the subordinated tranches because the holders of subordinated tranches are compensated for bearing a greater level of risk. As a result, dispersion of the interest rates on a legal entity's debt issuances may be an indicator that the subordination is substantive.

Factors	Description
Types of investors and how the interests were marketed	Evaluating the types of interest holders and understanding how those interests were marketed to them may provide an enterprise with insights into the design of, and subordination within, a legal entity's capital structure. This may help identify other circumstances that provide insight into whether subordination is substantive.

Question 3.3.90

Is subordination substantive if the legal entity's equity is sufficient to absorb its expected losses?

Interpretive response: Not necessarily. The subordination of equity interests generally is substantive if the equity is equity-at-risk (see section 4.3). In contrast, if the equity interests are not at risk, they might not provide evidence that a legal entity's subordination is substantive. For example, US GAAP equity that may be put (sold) back to the legal entity at its purchase price is not equity at risk because it does not absorb expected losses. As a result, the equity's subordination in this case is nonsubstantive.

There may also be situations in which the legal entity's equity at risk is not sufficient under the first VIE characteristic (see section 4.3), but the subordination of its capital structure is substantive. For example, a legal entity that has assets of $1,000, senior debt of $800, subordinated debt of $100 and equity of $100 has insufficient equity at risk if its expected losses exceed $100. However, the total subordination in the capital structure – i.e. equity and subordinated debt interests – may be substantive.

An enterprise should consider all relevant facts and circumstances before concluding on whether a legal entity's subordination is substantive.

3.3.30 Interest rate risk

Excerpt from ASC 810-10

Variable Interest Entities

> Determining the Variability to Be Considered

>> Certain Interest Rate Risk

25-33 Periodic interest receipts or payments shall be excluded from the variability to consider if the legal entity was not designed to create and pass along the interest rate risk associated with such interest receipts or payments to its interest holders. However, interest rate fluctuations also can result in variations in cash proceeds received upon anticipated sales of fixed-rate investments in an actively managed portfolio or those held in a static pool that, by design, will be required to be sold prior to maturity to satisfy obligations of the legal entity. That variability is strongly indicated as a variability that the legal entity was designed to create and pass along to its interest holders.

Virtually all legal entities are affected in some way by changes in interest rates, but only certain entities are designed to create and distribute interest rate risk to their interest holders.

Subtopic 810-10 acknowledges this by providing an example of a situation in which a legal entity is designed to create and distribute interest rate risk. A legal entity whose ability to meet its obligations and provide a return to its interest holders relies on proceeds from selling or settling fixed-rate financial instruments likely is designed to create and distribute variability due to interest rate risk. [810-10-25-33]

Question 3.3.100

Is it typical for a legal entity to identify interest rate risk as a risk it is designed to create and distribute in Step 2?

Interpretive response: No. Virtually all legal entities are affected in some way by changes in interest rates. Interest rate fluctuations are driven principally by macro-economic market forces and movements instead of entity-specific factors. As a result, many entities are not designed to create and distribute interest rate risk, including many that hedge such risk through the use of interest rate derivatives. Those that are not designed to create and distribute interest rate risk should exclude that risk from the risks identified in Step 2.

However, there are entities that are designed to create and distribute interest rate risk to their interest holders – in which case interest rate risk is identified in Step 2. A legal entity that relies on proceeds from selling fixed-rate financial instruments (or settling them before maturity) to meet its obligations and provide a return to its interest holders likely is designed to create and distribute variability due to interest rate risk. In that situation, the subordinated interest holders are exposed to changes in interest rates. If that subordination is substantive, it is a strong indication the legal entity was designed to create and distribute interest rate risk (see section 3.3.20).

Subtopic 810-10 provides examples of how to consider interest rate risk using the by design approach (see section 3.3.50). [810-10-55-59 – 55-64, 55-68 – 55-70]

Question 3.3.110

If the legal entity holds only financial assets, will it always identify interest rate risk in Step 2?

Interpretive response: No. Sometimes a legal entity that holds only financial assets is designed to create and pass along interest rate risk to its interest holders (see Question 3.3.100). However, in other situations, a legal entity that holds only financial assets may be designed to create and distribute only credit risk – e.g. if the entity holds only fixed-rate investments that it expects to hold until maturity.

Question 3.3.120

How should a legal entity compute its variability due to interest rate risk when it identifies that risk in Step 2?

Background: There are two primary methods used in practice to compute a legal entity's variability – the fair value method and the cash flow method (see chapter 10).

- **Fair value method.** Under the fair value method, variability is based on expected fair value changes. For example, variability is identified for a fixed-rate debt security due to changes in interest rates. This is because the discounted cash flow amount under each interest rate scenario will differ from the instrument's current fair value. Although the undiscounted cash flow amount does not change in each interest rate scenario, the discount rate does.
- **Cash flow method.** Under the cash flow method, variability is based on expected cash flow changes. For example, no variability is identified for a fixed-rate debt security due to changes in interest rates. This is because the discounted cash flow amount under each interest rate scenario will not differ from the instrument's current fair value. The undiscounted cash flow amount does not change in each interest rate scenario and neither does the discount rate.

Interpretive response: When a legal entity is designed to create and pass along interest rate risk to its interest holders, we believe it generally should compute its variability using the method that results in the greatest attribution of variability to the entity's subordinated interests. See Question 3.3.130 when both prepayment and interest rate risk exist.

Question 3.3.130

Are interest rate risk and prepayment risk considered separately when identifying risks in Step 2?

Interpretive response: Generally, no. We believe that prepayment risk and interest rate risk generally should be considered together.

Typically, legal entities that are designed to create and distribute prepayment risk are those that rely on variable cash inflows from their financial assets to satisfy their obligations and provide returns to their interest holders. Those entities are similarly exposed to interest rate risk because changes in interest rates also affect periodic cash flows. As a result, a legal entity that is designed to create and distribute prepayment risk generally is also designed to create and distribute interest rate risk.

When a legal entity is designed to create and distribute interest rate risk, we believe its variability generally should be computed using the method – i.e. fair value or cash flow – that results in the greatest attribution of variability to the entity's subordinated interests (see Question 3.3.120). As a result, we believe an enterprise that identifies prepayment/interest rate risk in Step 2 generally should compute the legal entity's variability using the fair value method.

3.3.40 Derivatives and the creator characteristics

Excerpt from ASC 810-10

Variable Interest Entities

> Determining the Variability to Be Considered

>> Certain Derivative Instruments

25-34 A legal entity may enter into an arrangement, such as a derivative instrument, to either reduce or eliminate the variability created by certain assets or operations of the legal entity or mismatches between the overall asset and liability profiles of the legal entity, thereby protecting certain liability and equity holders from exposure to such variability. During the life of the legal entity those arrangements can be in either an asset position or a liability position (recorded or unrecorded) from the perspective of the legal entity.

25-35 The following characteristics, if both are present, are strong indications that a derivative instrument is a creator of variability:

a. Its **underlying** is an observable market rate, price, index of prices or rates, or other market observable variable (including the occurrence or nonoccurrence of a specified market observable event).
b. The derivative counterparty is senior in priority relative to other interest holders in the legal entity.

25-36 If the changes in the fair value or cash flows of the derivative instrument are expected to offset all, or essentially all, of the risk or return (or both) related to a majority of the assets (excluding the derivative instrument) or operations of the legal entity, the design of the legal entity will need to be analyzed further to determine whether that instrument should be considered a creator of variability or a variable interest. For example, if a written call or put option or a total return swap that has the characteristics in (a) and (b) in the preceding paragraph relates to the majority of the assets owned by a legal entity, the design of the legal entity will need to be analyzed further (see paragraphs 810-10-25-21 through 25-29) to determine whether that instrument should be considered a creator of variability or a variable interest.

Entities use derivatives for a variety of reasons. They may be speculative investments, intended to introduce risk to the interest holders, or they may be risk management tools, intended to mitigate risk of the interest holders. Many types of derivatives can appear to switch roles – i.e. they are characterized as assets in some reporting periods and liabilities in others. [810-10-25-34]

A derivative can be a variable interest if it absorbs the variability a legal entity was designed to create and distribute. Therefore, the by-design approach applies when evaluating a derivative. However, Subtopic 810 provides incremental guidance specific to evaluating those instruments. That guidance, covered in this section, focuses on the nature of the derivative's underlying and the counterparty's seniority relative to other interest holders. Those characteristics, called the 'creator characteristics', may indicate if a derivative is a creator, or an absorber, of the variability of an entity. [810-10-25-35]

Question 3.3.140

What is the process for evaluating whether a derivative is a variable interest?

Interpretive response: The by-design approach requires an enterprise to understand the nature of the variability that a legal entity was designed to create and pass along to its interest holders when determining whether a derivative is a variable interest (see section 3.4.20). [810-10-25-22]

However, Subtopic 810-10 provides some operational relief for unsubordinated derivative contracts – e.g. plain vanilla interest rate swaps or foreign currency swaps. The guidance indicates that the presence of both of the following characteristics ('creator characteristics') is a strong indication that a derivative is a creator of variability – i.e. the derivative contract is not a variable interest. [810-10-25-35]

Creator characteristic 1	The derivative's underlying is an observable market rate, price, index of prices or rates, or other market observable variable, including the occurrence or nonoccurrence of a specified market observable event.
Creator characteristic 2	The counterparty to the derivative is senior in priority relative to the other interest holders in the entity – i.e. the counterparty is exposed to minimal credit risk.

However, even if the derivative meets both characteristics, an enterprise may need to further analyze a legal entity's design to determine if the derivative is a variable interest. This is the case if the changes in the fair value or cash flows of the derivative are expected to offset essentially all of the risks or returns associated with a majority of the legal entity's assets or operations (see Question 3.3.190). [810-10-25-36]

Question 3.3.150

Must a contract meet the definition of a derivative to apply the creator characteristics?

Interpretive response: Yes. A contract must meet the definition of a derivative under Topic 815 (derivatives and hedging) for an enterprise to rely on the creator characteristics. [815-10-15-83]

However, an enterprise may rely on the creator characteristics for a contract that meets the definition of a derivative but is excluded from the scope of Topic 815. [815-10-15-13]

Question 3.3.160

What is a 'market observable variable' when applying Creator characteristic 1?

Interpretive response: For the underlying to be a market observable variable, it should derive from sources external to the legal entity and to its interest holders – e.g. LIBOR, the Secured Overnight Financing Rate (SOFR), Treasury-based interest rate indices, and the Fed Funds Effective Swap Rate (OIS).

We also believe that a market observable variable is observable in an active market. A single market quote for an underlying in certain instances may not provide sufficient evidence that the underlying is market observable, even if it is obtained from external sources. However, an underlying associated with an asset that is considered readily convertible to cash under Topic 815 likely is a market observable variable. [815-10-15-119 – 15-139]

We do not believe that 'market observable' is analogous to 'observable inputs' under Topic 820 (fair value measurement). Under Topic 820, observable inputs are not limited to those that are observable in an active market. See chapter G in KPMG Handbook, Fair value measurement.

Significant professional judgment may be necessary in evaluating whether an underlying is market observable.

Question 3.3.170

What is 'senior in priority' when applying Creator characteristic 2?

Interpretive response: For a derivative counterparty to be considered 'senior in priority' relative to the other interest holders, we believe it must rank at least pari passu with the legal entity's most senior interest(s). We do not believe all other interest holders must be subordinate to the derivative counterparty for the derivative to meet Creator characteristic 2.

Example 3.3.60
Identifying variable interests in a synthetic CDO: credit default swap

Background

At formation, Legal Entity, a synthetic collateralized debt obligation (CDO), issues senior, subordinated and junior beneficial interests (collectively, Beneficial Interests) to fund the purchase of highly rated debt securities.

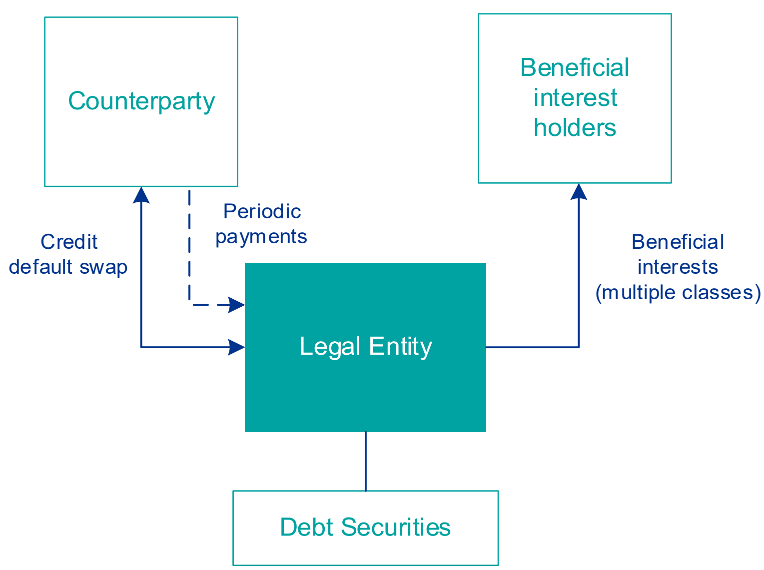
Legal Entity's subordination is substantive, which indicates that Legal Entity is designed to create and distribute the risks absorbed by the subordinated interests. Indicators that the subordination is substantive include differing interest rates and credit ratings among the classes of beneficial interests, which are commensurate with the relative exposure to default.

Legal Entity enters into a credit default swap with Counterparty that is indexed to a portfolio of corporate debt instruments (the 'underlying assets').

Under the terms of the credit default swap, Counterparty makes periodic premium payments to Legal Entity. In exchange, Legal Entity must do one of the following if a credit event occurs with respect to the underlying assets:

- purchase the underlying assets at par; or
- pay Counterparty the amount of the decrease in the fair value of the underlying assets.

Counterparty is senior in priority to any of Legal Entity's beneficial interest holders. If a credit event occurs with respect to the underlying assets, Legal Entity may be forced to sell its highly rated debt securities to make payments to Counterparty. This may result in Legal Entity having insufficient cash flows to service principal and interest payments to the Beneficial Interests.



Evaluation

The credit default swap creates variability because it meets the creator characteristics (see Question 3.3.140). The credit events on the underlying assets are market observable variables and Counterparty is senior in priority to the Beneficial Interests.

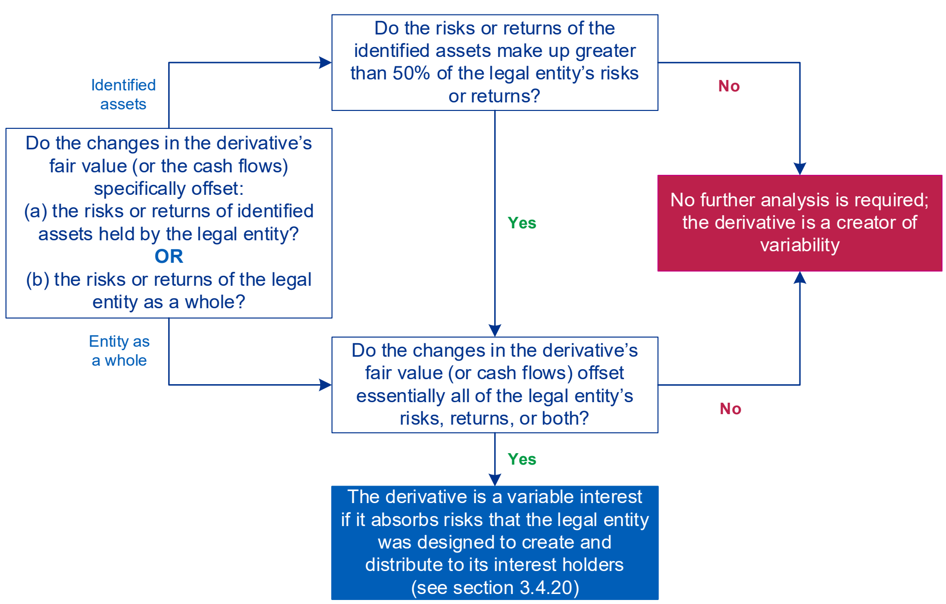
Because the credit default swap is a creator of variability (credit risk), Counterparty does not have a variable interest in Legal Entity. Although Counterparty has some exposure – e.g. if Legal Entity was unable to satisfy its obligations under the derivative – the derivative is structured to reduce that exposure. If the underlying assets experience a credit event, Counterparty is paid out of available capital first; the shortfall, if any, is first borne by the Beneficial Interests.

Question 3.3.180

Is a derivative exempt from being a variable interest if the creator characteristics are met?

Interpretive response: Not necessarily. Although meeting the creator characteristics is a strong indication that a derivative is a creator of variability (and therefore not a variable interest), it does not automatically exempt a derivative contract from being considered a variable interest.

An enterprise needs to further analyze a derivative contract that meets the creator characteristics if the changes in the derivative's fair value or cash flows offset essentially all of the risk and/or return from a majority of the legal entity's assets or operations. [810-10-25-36]



To determine whether further analysis of a derivative that meets the creator characteristics is necessary, an enterprise considers the following.

Question 3.3.190

How does an enterprise interpret the phrase 'essentially all' when evaluating whether a derivative is a variable interest?

Interpretive response: We believe the phrase 'essentially all' means the opposite of a trivial amount and should be analyzed relative to the legal entity's total risks or returns.

Determining whether a derivative offsets essentially all of a legal entity's aggregate risk or returns requires judgment. However, we believe the following guidelines should be applied.

DO consider	DON'T consider
— The magnitude of the total risk being offset — All relevant facts and circumstances	Whether a certain percentage (or portion) of each type of the entity's risk or reward is offset

The phrase 'essentially all' is also used in the context of whether a silo VIE exists within a VIE (see section 3.7). Under that guidance, a silo VIE does not exist when an asset is financed 100% with nonrecourse debt but the equity investors are entitled to the residual cash flows from the asset. The asset and the nonrecourse debt are not considered a silo VIE because the equity investors are entitled to more than a trivial amount of the asset's returns.

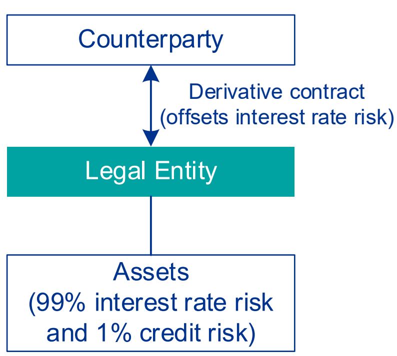
Example 3.3.70

Meaning of 'essentially all'

Background

Legal Entity's assets (excluding derivative instruments) are exposed to credit risk and interest rate risk. Interest rate risk comprises over 99% of the total risk in Legal Entity.

Counterparty enters into a derivative contract with Legal Entity that offsets all of Legal Entity's interest rate risk but none of its credit risk. The derivative does not offset the risk of any identified assets of Legal Entity.



Evaluation

The derivative offsets essentially all of the overall risk in Legal Entity even though it does not offset credit risk. However, the derivative is a variable interest only if Legal Entity is designed to create and distribute interest rate risk to its interest holders.

3.3.50 FASB examples

Excerpt from ASC 810-10

> Illustrations

>> Example 3: Determining the Variability to Be Considered

55-55 The following Cases illustrate the application of the guidance in paragraphs 810-10-25-21 through 25-36 for determining the variability to be considered in the following situations:

a. Financial VIE primarily financed by fixed-rate debt, holding investments in longer-term fixed-rate debt (Case A)
b. Financial VIE primarily financed by fixed-rate debt, holding investments in longer-term fixed- and variable-rate debt (with a fixed-rate swap) (Case B)
c. Financial VIE primarily financed by fixed-rate debt, holding investments in foreign-currency-denominated debt (with a currency swap) (Case C)
d. Financial VIE primarily financed by floating-rate debt, holding investments in fixed-rate securities (Case D)
e. Financial VIE financed by credit-linked notes holding highly rated floating-rate investments and a credit default swap (Case E)
f. Retail-operating VIE (Case F)
g. Lessor VIE (direct financing lease) with single lessee (operating lease) (Case G)
h. VIE holding both a fixed-price forward contract to buy and a fixed-price forward contract to sell electricity (Case H).

55-56 Cases A-H share all of the following assumptions:

a. All the entities are presumed to be VIEs.
b. All variable interests are variable interests in the VIE (as a whole) rather than variable interests in specified assets of the VIE, based on the guidance in paragraphs 810-10-25-55 through 25-59.
c. A primary beneficiary has not been identified; however, the determination of the primary beneficiary should be made in accordance with the guidance in paragraphs 810-10-25-38A through 25-38G.

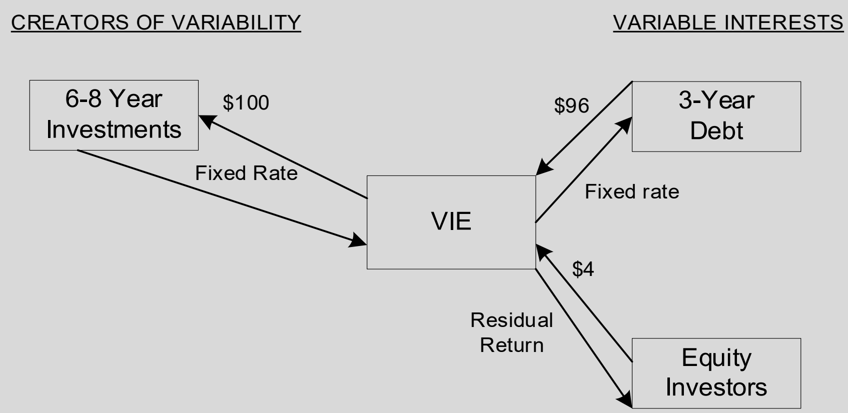
55-57 In each Case, a two-step evaluation is performed as follows:

a. Step 1: Analyze the nature of the risks in the VIE.
b. Step 2: Determine the purpose(s) for which the VIE was created and determine the variability the VIE is designed to create and pass along to its interest holders.

55-58 In the diagrams in each Case, creators are on the left and the variable interests are on the right; the instruments that could be considered either creators or absorbers of variability are in the bottom center.

>>> Case A: Financial VIE Primarily Financed by Fixed-Rate Debt, Holding Investments in Longer-Term Fixed-Rate Debt

55-59 A VIE is created and financed with $96 of 3-year fixed-rate debt and $4 of equity from investors. The VIE uses the proceeds to purchase $100 of B- and BB-rated fixed-rate securities with contractual maturities ranging from 6 to 8 years. At the end of three years, all the investments will be sold with proceeds used, first, to pay the fixed-rate debt holders and, second, to pay the equity holders to the extent proceeds remain. The transaction was marketed to potential debt investors as an investment in a portfolio of below-investment-grade, fixed-rate investments with a longer weighted-average maturity than the liabilities and credit support from the equity tranche. The equity tranche was negotiated to absorb the first dollar risk of loss related to credit risk and interest rate risk and to receive any residual reward from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of the investments in the portfolio. The following diagram illustrates this situation.



55-60 The VIE is exposed to the following risks:

a. Credit risk associated with a possible default by the issuers of the investments in the portfolio with respect to principal and interest payments
b. Interest rate risk associated with interim changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio
c. Interest rate risk associated with changes in cash received upon the sale of fixed-rate investments prior to maturity.

55-61 The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:

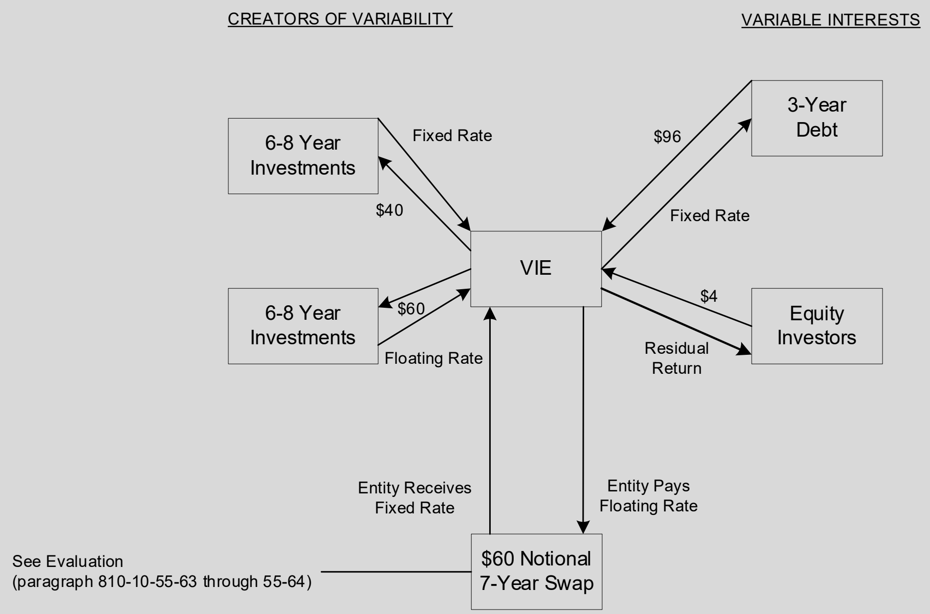
a. The VIE was marketed to debt investors as a VIE that will be exposed to credit risk and changes in the fair value of the investments over the three-year life of the VIE due to changes in intermediate-term interest rates, with the equity tranche negotiated to absorb the first dollar risk of loss. It has been determined that substantive subordination is present with respect to these risks.

b. The VIE was not designed to create and pass along to its interest holders interest rate risk associated with interim changes in fair value of the periodic fixed-rate interest payments received on the investments, based on the nature and terms of the debt and equity interests issued by the VIE.

Based on this analysis, it can be determined that the VIE was designed to create and pass along the risks in (a) and (c) in the preceding paragraph to the debt and equity investors, which are the VIE's variable interest holders.

>>> Case B: Financial VIE Primarily Financed by Fixed-Rate Debt, Holding Investments in Longer-Term Fixed- and Variable-Rate Debt (with a Fixed-Rate Swap)

55-62 A VIE is created and financed with $96 of 3-year fixed-rate debt and $4 of equity from investors. The VIE uses the proceeds to purchase $40 of B- and BB-rated fixed-rate securities with contractual maturities ranging from 6 to 8 years and $60 of B- and BB-rated floating-rate securities with contractual maturities ranging from 6 to 8 years (average maturity of 7 years). In addition, the VIE enters into a $60 notional 7-year pay floating and receive fixed interest rate swap with a bank. The swap economically converts the $60 of floating-rate investments to fixed-rate investments of the same average maturity. At the end of three years, all the investments will be sold, and the swap settled in cash, with the net proceeds used, first, to pay the fixed-rate debt holders and, second, to pay the equity holders to the extent proceeds remain. Net amounts payable to the swap counterparty periodically and at the end of three years (if required) take priority over payments made to the debt and equity investors. The transaction was marketed to potential debt investors as an investment in a portfolio of below-investment-grade fixed-rate and floating-rate investments (with the floating rate swapped for fixed) with a longer weighted-average maturity (including the effect of the swap) than the liabilities and credit support from the equity tranche. The equity tranche was negotiated to absorb the first dollar risk of loss related to credit risk and interest rate risk, and to receive any residual benefit from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of the investments in the portfolio (including settlement of the swap prior to its contractual maturity). The following diagram illustrates this situation.



55-63 The VIE is exposed to the following risks:

a. Credit risk associated with a possible default by the issuers of the investments in the portfolio with respect to principal or interest payments
b. Credit risk associated with a possible default by the swap counterparty with respect to interest payments and the settlement amount, if any, due to the VIE at the end of three years
c. Interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio and on the fixed leg of the swap
d. Interest rate risk associated with changes in the periodic interest payments received on the floating-rate investment portfolio
e. Interest rate risk associated with changes in cash received upon the sale of fixed-rate investments before maturity
f. Interest rate risk associated with the amount received or paid upon settlement of the swap at the end of three years.

55-64 The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:

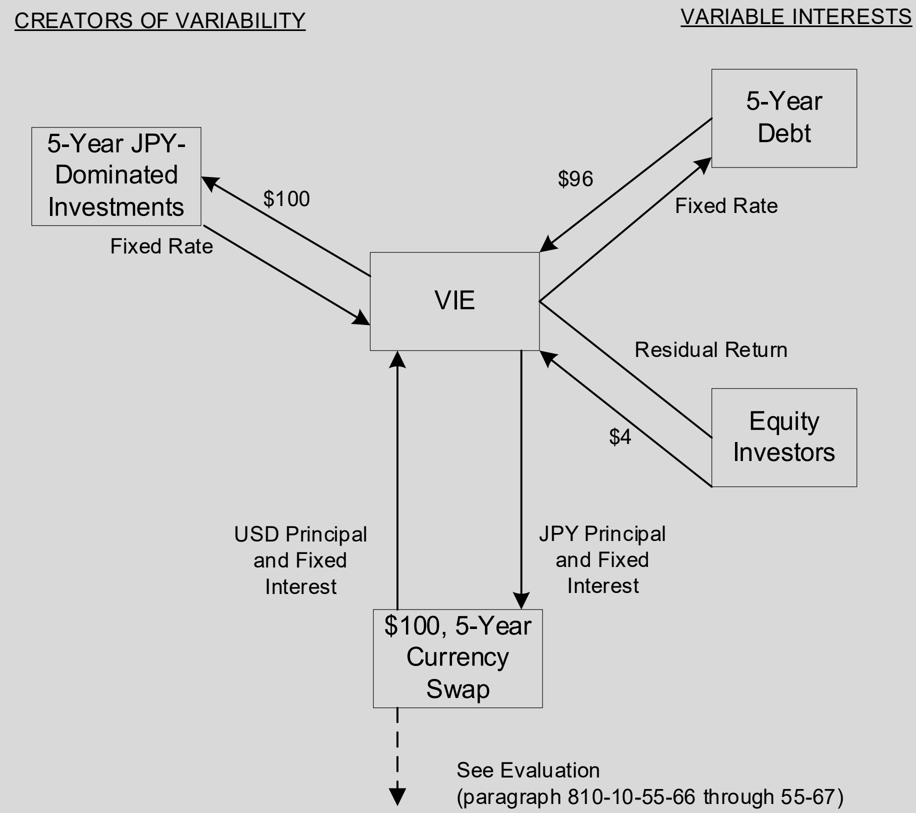
a. The VIE was marketed to debt investors as a VIE that will be exposed to credit risk and changes in the fair value of a portfolio of intermediate-term fixed-rate investments (including floating-rate investments effectively converted to fixed-rate investments by the swap) over the three-year life of the VIE due to changes in intermediate-term interest rates, with the equity tranche negotiated to absorb the first dollar risk of loss. It has been determined that substantive subordination is present with respect to these risks.
b. The swap counterparty is senior to the debt and equity investors, and the debt and equity investors understand that they are also exposed to the credit risk from possible default by the swap counterparty to the extent the swap is an asset to the VIE.

c. The interest rate swap is strongly indicated as a creator of variability because its underlying is based on observable market rates and it is senior in priority to other interest holders. Although the notional amount of the swap relates to a majority of the assets of the VIE, changes in the cash flows or fair value of the swap are not expected to offset all, or essentially all, of the risk or return (or both) related to those investments because the fair value and cash flows of the VIE's investments are expected to be affected by risk factors other than changes in market interest rates (that is, credit risk).
d. The VIE was not designed to create and pass along to its interest holders interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio and on the fixed leg of the swap, based on the nature and terms of the other contracts the VIE has entered into.
e. The VIE was not designed to create and pass along to its interest holders interest rate risk associated with changes in the periodic interest payments received on the floating-rate investment portfolio, based on the nature and terms of the debt and equity interests issued by the VIE.

Based on this analysis, it can be determined that the VIE was designed to create and pass along the risks in (a), (b), (e), and (f) in the preceding paragraph to the debt and equity investors, which are the VIE's variable interest holders. The interest rate swap is considered a creator of the VIE's variability based on the design of the VIE and the guidance in paragraphs 810-10-25-35 through 25-36.

>>> Case C: Financial VIE Primarily Financed by Fixed-Rate Debt, Holding Investments in Foreign-Currency-Denominated Debt (with a Currency Swap)

55-65 A VIE is created and financed with $96 of 5-year fixed-rate debt and $4 of equity from investors. The VIE uses the proceeds to purchase $100 of B- and BB-rated fixed-rate securities denominated in Japanese Yen (JPY) with contractual maturities of 5 years. In addition, the VIE enters into a $100 notional 5-year pay-fixed JPY and receive-fixed U.S. dollars (USD) cross-currency swap with a bank. The swap economically converts the fixed-rate JPY-denominated investments to fixed-rate USD investments, effectively offsetting the foreign exchange risk from both periodic interest payments and the amount due upon maturity for the JPY-denominated investments. At the end of five years, all the investments will mature and a final settlement will be paid or received by the VIE on the swap, with the net proceeds used, first, to pay the fixed-rate debt holders and, second, to pay the equity holders to the extent proceeds remain. The transaction was marketed to debt investors as an investment in a portfolio of below-investment-grade, JPY fixed-rate investments (with a third-party swap designed to offset the JPY exchange risk associated with interest and principal repayment on the investments) and credit support from the equity tranche. The equity tranche was negotiated to absorb the first dollar risk of loss. The following diagram illustrates this situation.



55-66 The VIE is exposed to the following risks:

a. Credit risk associated with a possible default by the issuers of the investments in the portfolio with respect to principal and interest payments
b. Credit risk associated with a possible default by the cross-currency swap counterparty with respect to interest payments and the settlement amount, if any, due to the VIE at the end of five years
c. Interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio and on the receive leg of the cross-currency swap
d. Foreign currency exchange risk associated with the periodic interest payments received on the fixed-rate JPY-denominated investments and the final receipt of principal at maturity
e. Foreign currency exchange risk associated with the periodic interest payments or receipts and the amount received or paid upon final settlement of the cross-currency swap at the end of five years.

55-67 The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:

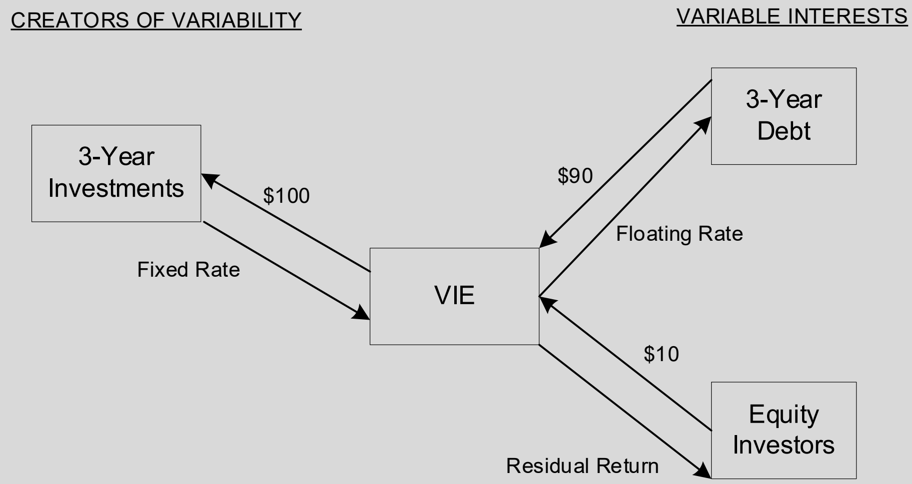
a. The VIE was marketed to debt investors as a VIE that will be exposed to credit risk from possible default by the issuers of the JPY-denominated investments (principal and interest) as well as credit risk from possible default by the cross-currency swap counterparty, with the equity tranche negotiated to absorb the first dollar risk of loss related to these risks. It has been determined that substantive subordination is present with respect to these risks.

b. The VIE was created to provide an investment vehicle for debt and equity investors to be exposed to the credit risk of entities whose securities are denominated in JPY.
c. The swap counterparty is senior to the debt and equity investors, and the debt and equity investors are also exposed to the credit risk from possible default by the swap counterparty to the extent the swap is an asset to the VIE.
d. The currency swap is strongly indicated as a creator of variability because its underlying is based on observable market rates and it is senior in priority to other interest holders. Although the notional amount of the swap relates to a majority of the assets of the VIE, changes in the cash flows or fair value of the swap are not expected to offset all, or essentially all, of the risk or return (or both) related to those investments because the fair value and cash flows of the VIE's investments are expected to be affected by risk factors other than changes in foreign currency exchange rates (that is, credit risk).
e. The VIE was not designed to create and pass along to its interest holders interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio and on the receive leg of the cross-currency swap, based on the nature and terms of the debt and equity contracts issued by the VIE.

Based on this analysis, it can be determined that the VIE was designed to create the risks in (a), (b), (d), and (e) in the preceding paragraph, and pass along the risks in (a) and (b) in the preceding paragraph to the debt and equity investors, which are the VIE's variable interest holders. The cross-currency swap is considered a creator of the VIE's variability based on the design of the VIE and the guidance in paragraphs 810-10-25-35 through 25-36.

>>> Case D: Financial VIE Primarily Financed by Floating-Rate Debt, Holding Investments in Fixed-Rate Securities

55-68 A VIE is created and financed with $90 of 3-year floating-rate debt and $10 of equity from investors. The VIE uses the proceeds to purchase $100 of AAA-rated fixed-rate securities, which mature in 3 years. The fixed periodic interest payments received on the investments are used to pay the floating-rate interest to the debt holders with the remainder used to provide a return to the equity investor. At the end of three years, all the investments will mature with proceeds used, first, to pay the floating-rate debt holders and, second, to pay the equity holder to the extent proceeds remain. The VIE is not actively managed. The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality fixed-rate investments with the equity tranche negotiated to provide support in the event of a credit default on the investments or in the event the fixed-rate return on the investments is not sufficient to pay the floating-rate coupon on the debt. The equity tranche was negotiated to absorb the first dollar risk of loss. The following diagram illustrates this situation.



55-69 The VIE is exposed to the following risks:

a. Credit risk associated with a possible default by the issuers of the investments in the portfolio with respect to principal or interest payments
b. Interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio.

55-70 The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:

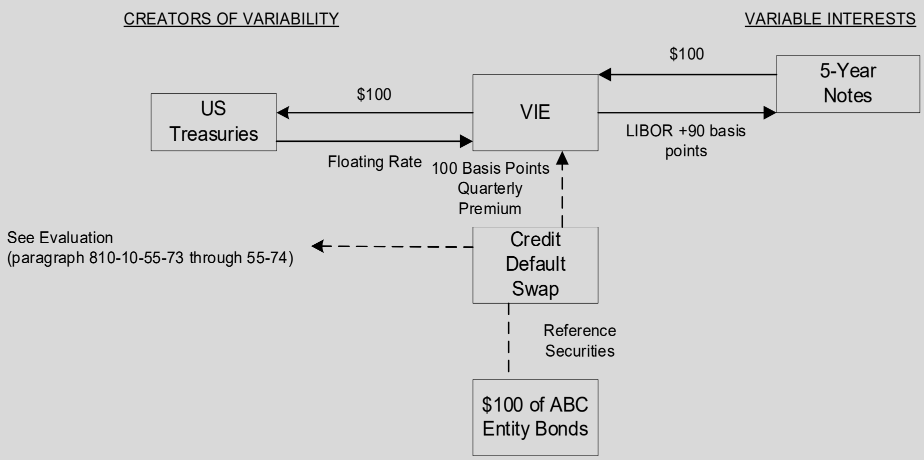
a. The VIE was marketed to debt investors as an entity that will be exposed to changes in the fair value of periodic interest payments received on the investments due to changes in interest rates and credit risk associated with the investment portfolio, with the equity tranche negotiated to absorb the first dollar risk of loss. It has been determined that substantive subordination is present with respect to these risks.
b. The equity investor has implicitly issued a $90 notional interest rate swap to the VIE in which that investor agrees to pay the VIE a floating rate and receive a fixed rate. However, the maximum amount payable to the VIE is limited to the equity investment. The debt holders will absorb the remaining variability caused by changes in interest rates.
c. The VIE was created to provide an investment vehicle for debt and equity investors to be exposed to the credit risk and interest rate risk associated with a mismatch between the assets (fixed-rate) and liabilities (floating-rate).
d. The VIE was designed to create and pass along to its interest holders interest rate risk associated with changes in fair value of the periodic fixed-rate interest payments received on the investments, based on the nature and terms of debt and equity interests issued by the VIE.

Based on this analysis, it can be determined that the VIE was designed to create and pass along the risks in (a) and (b) in the preceding paragraph to the debt and equity investors, which are the VIE's variable interest holders.

>>> Case E: Financial VIE Financed by Credit-Linked Notes Holding Highly Rated Floating-Rate Investments and a Credit Default Swap

55-71 Bank A holds a $100 investment in bonds issued by ABC Entity and enters into a credit default swap with a newly established VIE that has no equity investors and no decision-making ability. The VIE issues $100 of credit-linked notes to investors. The credit-linked notes pay a return equal to the London Interbank Offered Rate (LIBOR) + 90 basis points and mature in 5 years. The proceeds from the issuance of the credit-linked notes are invested in floating-rate AAA-rated investments. The terms of the credit default swap require Bank A to pay quarterly a swap premium of 100 basis points to the VIE. If a credit event occurs, as defined in the agreement, the VIE pays Bank A the notional amount of $100, and receives from Bank A the bonds issued by ABC Entity. The VIE then settles its five-year notes by delivering to the note holder the defaulted ABC Entity bonds or by selling the bonds and delivering cash.

55-72 The coupon on the floating-rate AAA-rated investments, plus the premium received on the credit default swap, will fund the coupon payment on the credit-linked notes. The VIE was marketed to potential investors as a floating-rate investment with an enhanced yield due to the assumption of credit risk of the referenced entity (in this case, ABC Entity). The following diagram illustrates this situation.



55-73 The VIE is exposed to the following risks:

a. Credit risk associated with ABC Entity
b. Credit risk associated with the AAA-rated investments
c. Credit risk associated with possible default by Bank A with respect to premium payments made to the VIE
d. Interest rate risk associated with changes in the cash flows from the interest payments received on the floating-rate investments.

55-74 The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:

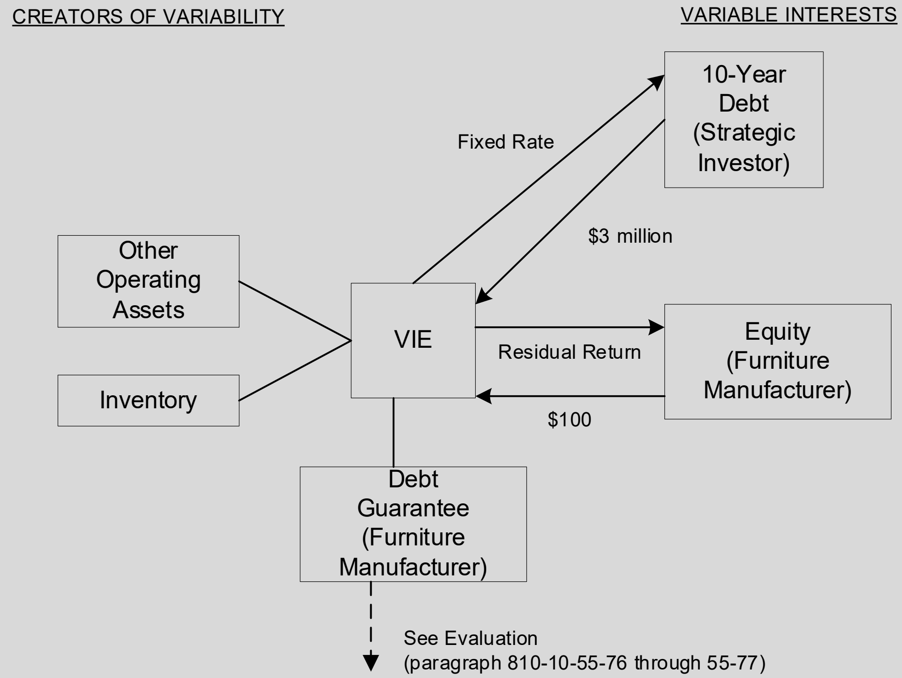
a. The VIE was marketed to the note holders as a VIE that will be exposed to credit risk associated with ABC Entity through the credit default swap, with a small amount of credit risk from Bank A, because the notes, if there is no credit event that triggers settlement of the credit default swap, are fully collateralized by AAA-rated investments.

b. The VIE has sold credit protection on ABC Entity to Bank A and has purchased credit protection on ABC Entity from the note holders, who are expected to receive an enhanced return over the AAA floating rate investment for assuming the credit risk of ABC Entity and (to a lesser extent) the credit risk of Bank A.
c. The written credit default swap is strongly indicated as a creator of variability because its underlying is based on observable market variables and it is senior in priority to other interest holders.
d. The VIE was not designed to create and pass along to its interest holders interest rate risk associated with changes in cash flows from the periodic interest payments received on the floating-rate investments, based on the nature and terms of the credit-linked notes issued by the VIE.

Based on this analysis, it can be determined that the VIE was designed to create and pass along the risks in (a), (b), and (c) in the preceding paragraph to the note holders, which are the VIE's variable interest holders. The written credit default swap is considered a creator of the VIE's variability based on the design of the VIE and considering the guidance in paragraphs 810-10-25-35 through 25-36.

>>> Case F: Retail-Operating VIE

55-75 A VIE is created by a furniture manufacturer and a strategic investor to sell wood furniture to retail customers in a particular geographic region of the country that has no viable distribution channel. The VIE is established with $100 of equity contributed by the furniture manufacturer and $3 million of 10-year fixed-rate debt financed by the strategic investor. Interest is paid to the fixed-rate debt holder from operations before funds are available to the equity holder. The furniture manufacturer has guaranteed the fixed-rate debt to the strategic investor. The following diagram illustrates this situation.



55-76 The VIE is exposed to the following risks (collectively, operating risks):

a. Sales volume risk
b. Retail furniture price risk
c. Inventory price risk
d. Other operating cost risk.

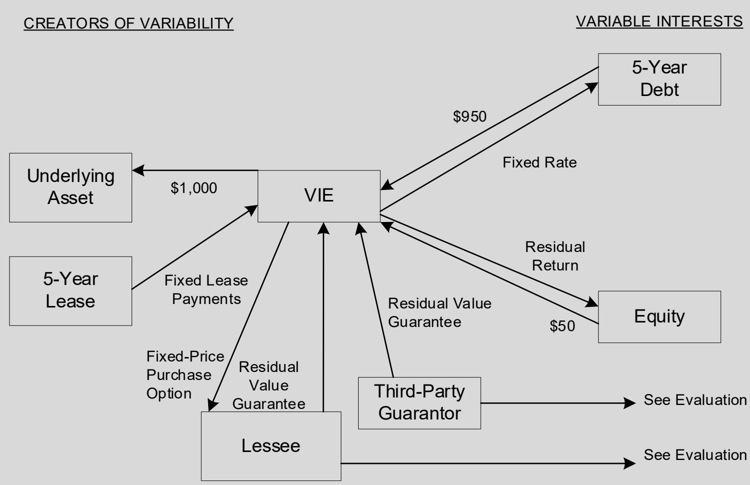
55-77 The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:

a. The VIE was created to enable the furniture manufacturer to extend its existing business line into a particular geographic region that lacked a viable distribution channel.
b. The furniture manufacturer is absorbing variability from the operations of the VIE through its guarantee of the debt.
c. The debt interest was negotiated as a fixed-rate investment in a retail operating VIE, supported by the furniture manufacturer.

Based on this analysis, it can be determined that the VIE was designed to create and pass along the risks in (a), (b), (c), and (d) in the preceding paragraph to the debt and equity investors (the strategic investor and furniture manufacturer, respectively), which are the VIE's variable interest holders. The furniture manufacturer also holds a variable interest with respect to its guarantee of the debt of the VIE because that contract, by design, absorbs a portion of the VIE's variability due to operating risks.

>>> Case G: Lessor VIE (Direct Financing Lease) with Single Lessee (Operating Lease)

55-78 A VIE is created and financed with $950 of 5-year fixed-rate debt and $50 of equity. The VIE uses the proceeds from the issuance to purchase an **underlying asset** to be leased to a **lessee** with a AA credit rating. The equity provides protection (up to $50) to the debt related to both credit risk and interest rate risk because the debt is paid before any cash flows are available to the equity investors. The **lease** has a five-year term and is classified as a **direct financing lease** by the **lessor** and as an **operating lease** by the lessee. The lessee is required to provide a first-loss residual value guarantee for the expected future value of the underlying asset at the end of five years, and it has a fixed-price purchase option to acquire the underlying asset for the same amount. A third-party residual value guarantor provides a very small additional residual value guarantee to the lessor. The governing documents for the VIE do not permit the VIE to buy additional assets or sell existing assets during the five-year holding period. The VIE was formed so that the lessee will have rights to occupy and use the underlying asset under an operating lease and retain substantially all of the risks and rewards from appreciation or depreciation in value of the underlying asset. The transaction was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by an underlying asset that would provide a fixed-rate return to debt holders equivalent to AA-rated assets. The return to equity investors is expected to be slightly greater than the return provided to the debt investors because the equity is subordinated with respect to the obligation of the lessee to the VIE. The following diagram illustrates this situation.



55-79 The VIE is exposed to the following risks:

a. Price risk with respect to changes in fair value of the underlying asset
b. Credit risk associated with possible default by the lessee of the underlying asset with respect to the lease payments
c. Interest rate risk associated with changes in the fair value of the future lease payments.

55-80 The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:

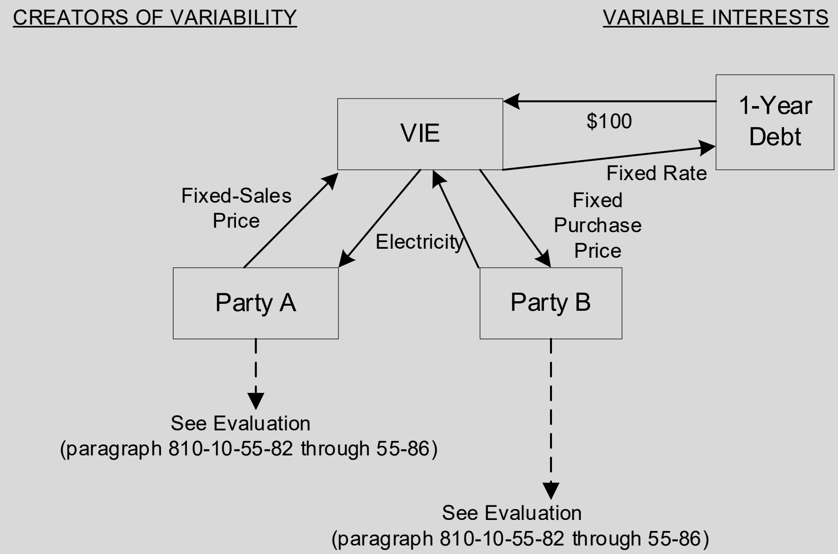
a. Although the lease payments are fixed, the VIE was not designed to be exposed to interim changes in fair value of those lease payments due to interest rate risk because the VIE is not expected to sell the underlying asset before maturity of the fixed-rate debt.

b. The primary purpose for which the VIE was created was to provide the lessee with use of the underlying asset for five years with substantially all of the rights and obligations of ownership.
c. The residual value guarantee effectively transfers substantially all of the risk associated with the underlying asset (that is, declines in value) to the lessee. Therefore, the variability that is transferred to that interest holder is strongly indicated as variability that the VIE is designed to create and pass along to its interest holders.
d. The fixed-price purchase option effectively transfers substantially all of the rewards from the underlying asset (that is, increases in value) to the lessee.
e. The VIE is designed to be exposed to the risks associated with a cumulative change in fair value of the underlying asset at the end of five years as well as credit risk from possible default by the lessee with regard to lease payments.
f. The VIE was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by an underlying asset that would provide a fixed-rate return to debt holders equivalent to AA-rated assets.
g. The role of the residual value guarantee and fixed-price purchase option in the design of the VIE, regardless of their legal form or accounting classification, dictates whether those interests shall be treated as creating risk for the VIE or absorbing risk from the VIE. Therefore, price risk with respect to changes in fair value of the underlying asset is a relevant risk for the VIE, even though the lessor VIE records a net investment in the direct financing lease, rather than the underlying asset itself, on its balance sheet for accounting purposes.

Based on this analysis, it can be determined that the VIE was designed to create and pass along the risk in (a) in paragraph 810-10-55-79 to the third-party guarantor and the lessee (with respect to the residual value guarantee and fixed-price purchase option) and the risk in (b) in paragraph 810-10-55-79 to the note and equity holders, all of which are the VIE's variable interest holders.

>>> Case H: VIE Holding Both a Fixed-Price Forward Contract to Buy and a Fixed-Price Forward Contract to Sell Electricity

55-81 A financially distressed electricity producer wishes to monetize some of its in-the-money forward positions. One such contract is a physically settled forward contract to sell electricity to Party A at a fixed price one year in the future. A VIE is created and financed with $100 of 1-year fixed-rate debt from investors for the purpose of monetizing the value of the forward contract to sell for the electricity producer. The VIE uses the proceeds from issuance to purchase the physically settled forward contract to sell (from the VIE's perspective) electricity to Party A at a fixed price one year in the future. This contract is in-the-money by $100. After the electricity producer has received its $100, it has no further involvement with the VIE. The VIE enters into a separate at-market forward contract to buy (from the VIE's perspective) electricity at a lower fixed price from Party B on the same future date. Both forward contracts will be physically settled, and all other critical terms (except the fixed settlement price) of the two forward contracts are the same. Both forward contracts have rights senior to those of the investors and are derivatives whose underlying is a market observable price. The VIE is not actively managed. The debt was marketed to the investors as a fixed-rate one-year investment with an enhanced yield due to risk of possible default by either Party A or Party B with respect to their forward contracts with the VIE. The following diagram illustrates this situation.



55-82 The VIE is exposed to the following risks:

a. Electricity price risk, which affects the fair values of the fixed-price forward purchase contract and the fixed-price forward sales contract
b. Credit risk associated with possible default by the counterparty to the forward purchase contract
c. Credit risk associated with possible default by the counterparty to the forward sales contract.

55-83 The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:

a. The VIE was designed to hold offsetting positions with respect to electricity price risk through a forward purchase contract and a forward sales contract with terms that are the same (except for fixed settlement price).
b. The debt was marketed to the investors as a fixed-rate one-year investment with an enhanced yield due to risk of possible default by either Party A or Party B with respect to their forward contracts with the VIE.
c. To the extent electricity prices rise and the forward purchase contract (with Party B) increases in value (from the VIE's perspective), the debt investors will be exposed to credit risk to the extent that Party B defaults on its obligation.
d. To the extent electricity prices drop and the forward sales contract increases in value (from the VIE's perspective), the debt investors will be exposed to credit risk to the extent that Party A defaults on its obligation.
e. The forward to buy electricity at a fixed price is strongly indicated as a creator of variability because its underlying is based on observable market prices and it is senior in priority to the debt holders.

f. The forward to sell electricity at a fixed price is strongly indicated as a creator of variability because its underlying is based on observable market prices and is senior in priority to the debt holders.
g. Changes in fair value of each forward contract are expected to offset all, or essentially all, of the risk and return related to the other forward contract, so a further analysis of the design of the VIE is necessary in order to conclude whether each forward contract is a creator of variability or a variable interest.

55-84 A further analysis of the design of the VIE is necessary to conclude whether each fixed-price forward contract is a creator of variability or a variable interest because changes in the fair value of each contract are expected to offset all, or essentially all, of the risk and return related to the other contract. That analysis should consider the following factors:

a. The debt interests in this VIE were marketed on behalf of the electricity producer as fixed-rate debt exposed to the credit risk of the counterparties to the forward agreements.
b. The counterparties to the forward agreements did not participate significantly in the design of the VIE.

55-85 In these circumstances, because they meet the characteristics described in paragraph 810-10-25-35(a) through (b) and based on the further analysis of the design of the VIE, the two forward contracts are creators of the VIE's variability. Based on this analysis, it can be determined that the VIE was designed to create and pass along the risks in paragraph 810-10-55-82(a) through (c) to the debt investors, which are the VIE's variable interest holders.

55-86 If, instead of executing the transaction described in this Case, the electricity producer sold the fixed-price forward sales contract for $100 to an entity that physically owned a power plant and produced electricity, an analysis of the design of that entity would be required, which would involve developing a complete understanding of the purpose for which that entity was created. In this case, the electricity producer also has no further involvement with the entity after receiving its $100. Provided the fixed-priced forward contract to sell is senior in priority to other interest holders, that contract would be strongly indicated as a creator of variability because its underlying is based on observable market rates. In addition, changes in the cash flows or fair value of the fixed-price forward contract typically would not be expected to offset all, or essentially all, of the risk or return (or both) related to the power plant because the risk or return (or both) of the power plant would be affected by factors other than changes in electricity prices (for example, operating costs).

3.4 Explicit interests

3.4.10 Equity, debt and beneficial interests

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

>>> Equity Investments, Beneficial Interests, and Debt Instruments

55-22 Equity investments in a VIE are variable interests to the extent they are at risk. (Equity investments at risk are described in paragraph 810-10-15-14.) Some equity investments in a VIE that are determined to be not at risk by the application of that paragraph also may be variable interests if they absorb or receive some of the VIE's variability. If a VIE has a contract with one of its equity investors (including a financial instrument such as a loan receivable), a reporting entity applying this guidance to that VIE shall consider whether that contract causes the equity investor's investment not to be at risk. If the contract with the equity investor represents the only asset of the VIE, that equity investment is not at risk.

55-23 Investments in subordinated beneficial interests or subordinated debt instruments issued by a VIE are likely to be variable interests. The most subordinated interest in a VIE will absorb all or part of the expected losses of the VIE. For a voting interest entity the most subordinated interest is the entity's equity; for a VIE it could be debt, beneficial interests, equity, or some other interest. The return to the most subordinated interest usually is a high rate of return (in relation to the interest rate of an instrument with similar terms that would be considered to be investment grade) or some form of participation in residual returns.

55-24 Any of a VIE's liabilities may be variable interests because a decrease in the fair value of a VIE's assets could be so great that all of the liabilities would absorb that decrease. However, senior beneficial interests and senior debt instruments with fixed interest rates or other fixed returns normally would absorb little of the VIE's expected variability. By definition, if a senior interest exists, interests subordinated to the senior interests will absorb losses first. The variability of a senior interest with a variable interest rate is usually not caused by changes in the value of the VIE's assets and thus would usually be evaluated in the same way as a fixed-rate senior interest. Senior interests normally are not entitled to any of the residual return.

Equity, debt and beneficial interests are called explicit interests because they directly absorb or receive a legal entity's variability. The following table indicates whether they qualify as variable interests.

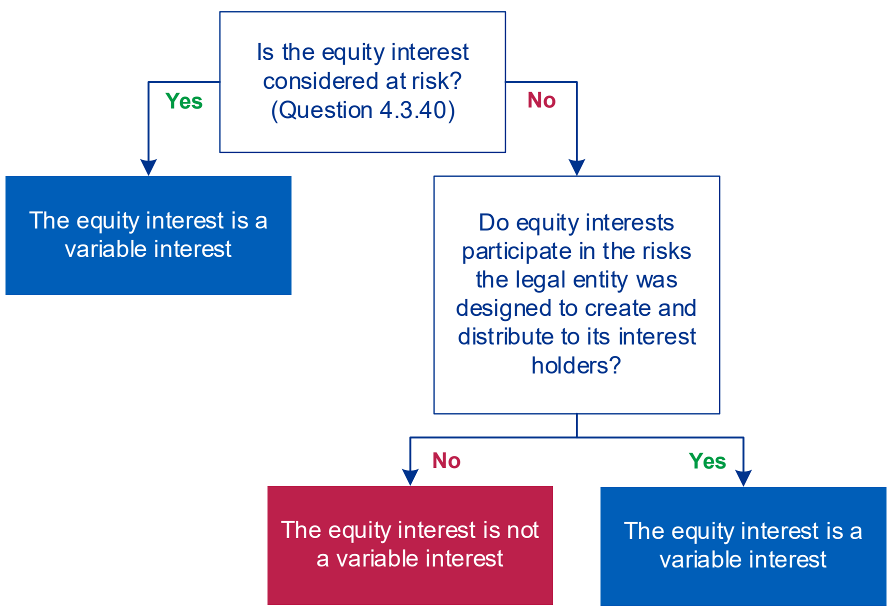
Type of interest	Variable interest?	Reference
Equity at risk	✓	Question 3.4.10
Equity not at risk	?	Question 3.4.10
Debt obligation	✓	Question 3.4.30
Beneficial interest (other than a derivative)	✓	Question 3.4.40 For derivatives, see sections 3.3.40 and 3.4.20

The degree of variability absorbed by debt instruments and beneficial interests depends on the level of subordination of the interest. The more subordinated an interest, the more variability it will absorb. [810-10-55-23 – 55-24]

Question 3.4.10#

Is an equity interest a variable interest?

Interpretive response: Generally, yes. If an equity interest is an equity investment at risk (see section 4.3), it is a variable interest. If an equity investment that is not at risk absorbs or receives some of the variability that the legal entity was designed to create and distribute to its interest holders, it is a variable interest. Whether an equity interest that is not at risk is a variable interest often depends on the facts and circumstances, including the reason that the equity interest is not considered to be at risk. [810-10-55-22 – 55-24]



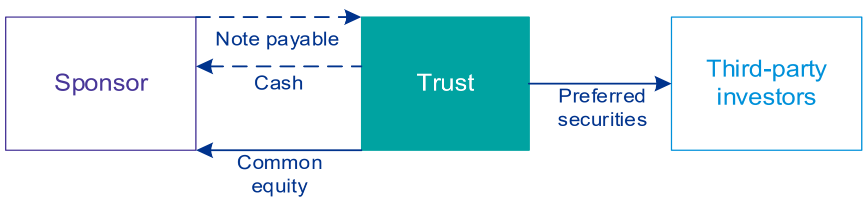
For example, an equity interest must participate significantly in the legal entity's US GAAP profits and losses to be considered an equity investment at risk (the first at-risk requirement, see Question 4.3.40). If an equity investment participates significantly in losses but not profits, such as when an equity interest is subject to a fixed-price call option held by the legal entity (see Question 4.3.140), then this requirement has not been met and the equity interest is not an equity investment at risk. However, the equity interest may yet absorb some portion of the legal entity's expected losses – i.e. some of the variability that the legal entity was designed to create and distribute to its interest holders. In that situation, although the equity interest is not an equity investment at risk, it is a variable interest.

In contrast, an equity interest that is not at risk is not a variable interest if it is not exposed to the legal entity's variability. An example is when the equity investor also enters into a contract with the VIE and that contract is the only asset of the VIE. In that case, the equity interest is neither at risk nor a variable interest because it both creates and absorbs the variability (see Question 3.4.20). [810-10-55-22]

Question 3.4.20

Is a sponsor's equity interest in a typical trust preferred (or similar) structure a variable interest?

Background: In a typical trust preferred securities structure, a sponsor (usually a bank), establishes a limited purpose trust (Trust) by contributing cash in exchange for all of the Trust's common equity. The purpose of the Trust is to issue trust preferred securities to third-party investors and use the proceeds of the issuance to extend an equal amount of financing to the sponsor. The financing to the sponsor is typically in the form of junior subordinated debentures, notes or other instruments that have stated maturity dates (the 'notes').



The notes are the only assets of the Trust. When the sponsor makes its interest payments on the notes, the Trust distributes the cash to the holders of the trust-preferred securities. The trust-preferred securities must be redeemed on maturity of the notes.

Interpretive response: Generally, no. We do not believe an enterprise has a variable interest in an entity if it both creates the variability and absorbs it – i.e. a variable interest holder cannot absorb variability that it alone creates (see Question 3.3.50). This is often the case in structures in which an interest holder creates the credit risk variability in the VIE because it borrows from the Trust.

In this example, the variability to be absorbed by the sponsor's common equity interest in Trust depends on the sponsor's creditworthiness – i.e. its ability to repay the notes. This means that the Trust was designed to create and distribute the sponsor's credit risk to the sponsor. As a result, the sponsor's common equity in Trust is not an equity investment at risk (see section 4.3) or a variable interest. [810-10-55-22]

However, if the Trust instead owned common stock of the sponsor's, it may be designed to create and distribute equity price risk, instead of credit risk, to the sponsor. In that situation, the sponsor generally is not the sole source of equity price risk (like it is for credit risk) because equity price risk depends on a variety of internal and external economic factors (see Example 3.4.10).

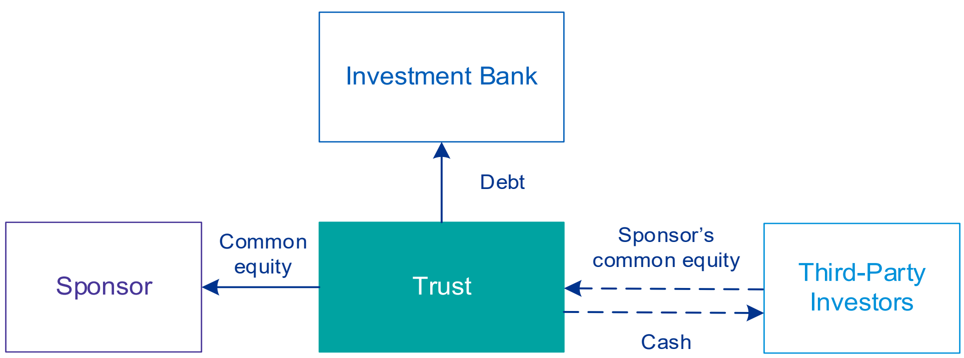
Example 3.4.10
Treasury stock financing structure

Background

Sponsor engages Investment Bank to help it reduce the number of its outstanding common shares. To do so, Sponsor forms Trust by contributing cash in exchange for all of Trust's common equity. Further, Trust:

— issues debt to Investment Bank in exchange for cash; and
— purchases Sponsor's common shares in the open market with the funds received from the debt issuance.

The interest payments on the debt are structured to match the dividends received by Trust on the common shares.



Evaluation

Sponsor has a variable interest in Trust because Trust was designed to create and distribute equity price risk and Sponsor absorbs that risk through its common equity interest.

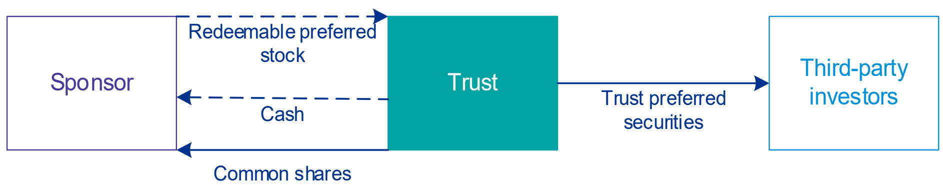
Both interest holders face risk of loss if the share price of the common shares were to decline significantly. However, Investment Bank's debt is a senior interest and therefore has a lower risk of loss because it would be paid in full before any distributions are made to Sponsor as the common equity holder. Similarly, Investment Bank's upside is capped at the principal and interest on its debt holding and Sponsor's upside is not capped. These facts support that equity price risk is the risk that Trust was designed to create and distribute to its interest holders.

Further, Sponsor does not create the equity price risk. Equity price risk is created by a variety of internal and external economic factors.

Example 3.4.20
Reverse trust preferred security arrangement

Background

Sponsor forms Trust by contributing cash in exchange for all of Trust's common shares. Trust issues trust preferred securities to third-party investors and uses the proceeds to purchase Sponsor's mandatorily redeemable preferred stock. Under Topic 480 (liabilities vs equity), Sponsor accounts for the mandatorily redeemable preferred stock as a liability.



Evaluation

Although Trust's asset is in-form an equity interest in Sponsor, we believe this scenario should be analyzed in the same manner as a typical trust preferred structure (see Question 3.4.20).

The variability to be absorbed by Sponsor's common equity interest in Trust depends on Sponsor's creditworthiness – i.e. its ability to redeem the preferred stock. This means that the Trust was designed to create and distribute the Sponsor's credit risk to Sponsor. As a result, Sponsor's common equity in Trust is not an equity investment at risk (see section 4.3) or a variable interest.

Question 3.4.30
Are a legal entity's debt obligations always variable interests?

Interpretive response: Yes. A legal entity's debt obligations – including the obligation to pay the related interest – are always variable interests.

However, the amount of variability absorbed by a debt instrument depends on: [810-10-55-23 – 55-24]

— its level of seniority in the legal entity's capital structure – the more senior the debt instrument, the less variability it will absorb; and

— the risks that the legal entity was designed to create and distribute to its variable interest holders. The variability absorbed by debt instruments will be limited for legal entities that are not designed to create and distribute interest rate risk to their interest holders (see Question 3.3.100).

Example 3.4.30
Debt obligations

Background

Legal Entity has the following capital structure based on fair values, listed from most senior to least senior.

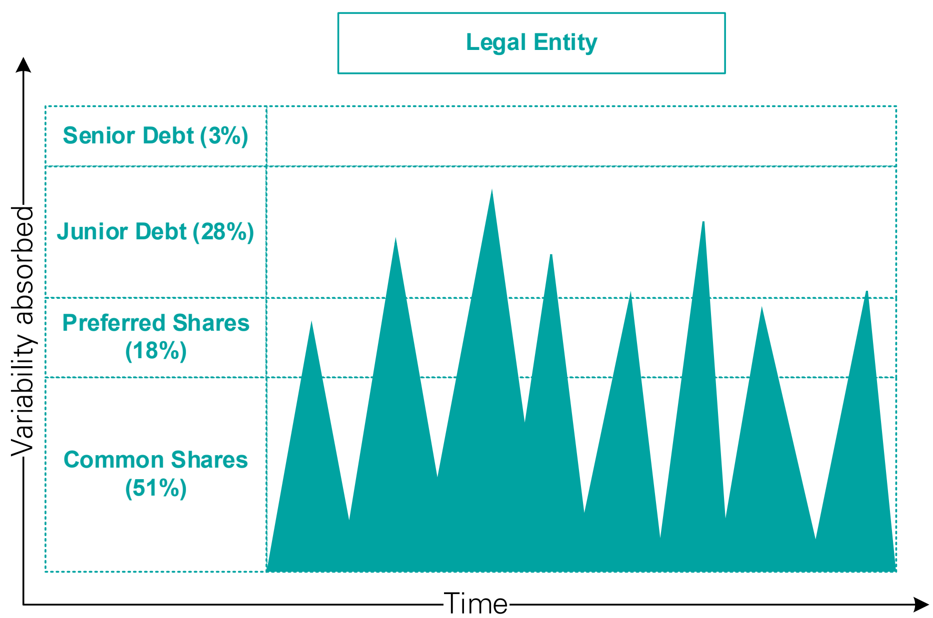
Senior debt	3%
Junior debt	28%
Preferred shares	18%
Common shares	51%

— Interest on senior debt is variable, based on a rolling 12-month average of the secured overnight financing rate (SOFR) plus 2%, payable monthly.

— Interest on junior debt is fixed at a rate of 5%, payable monthly.

— Preferred shares have an 8% accumulating dividend, payable quarterly in arrears.

— Legal Entity's subordination is substantive.



Evaluation

While all of the debt and equity holders have a variable interest in Legal Entity, the debt likely absorbs little of Legal Entity's expected variability based on the following considerations.

— Although changes in interest rates result in changes in the cash flows associated with the senior debt and changes in the fair value of the junior debt, that variability is market driven, not entity driven.

— Legal Entity's subordination is substantive, which indicates that Legal Entity was designed to create and distribute to its interest holders the risks that are absorbed by its subordinated interests.
— Legal Entity has a significant amount of equity available to absorb variability.

Question 3.4.40

Are a legal entity's beneficial interests always variable interests?

Interpretive response: Yes. Similar to debt instruments, a legal entity's beneficial interests that are not derivatives (see section 3.4.10) – including the obligation to pay the related interest – are always variable interests.

Although we believe all beneficial interests that are not derivatives are variable interests, the amount of variability absorbed by a beneficial interest depends on: [810-10-55-23 – 55-24]

— its level of seniority in the legal entity's capital structure; and
— the risks that the legal entity was designed to create and distribute to its interest holders (see section 3.3).

Example 3.4.40

Identifying variable interests in a synthetic CDO: beneficial interests

Background

At formation, Legal Entity, a synthetic CDO, issues senior, subordinated, and junior beneficial interests (collectively, Beneficial Interests) to fund the purchase of highly rated debt securities.

Legal Entity's subordination is substantive, which indicates that Legal Entity is designed to create and distribute the risks absorbed by the subordinated interests. Indicators that the subordination is substantive include differing interest rates and credit ratings among the classes of beneficial interests, which are commensurate with the relative exposure to default.

Legal Entity enters into a credit default swap with Counterparty that is indexed to a portfolio of corporate debt instruments (the 'underlying assets').

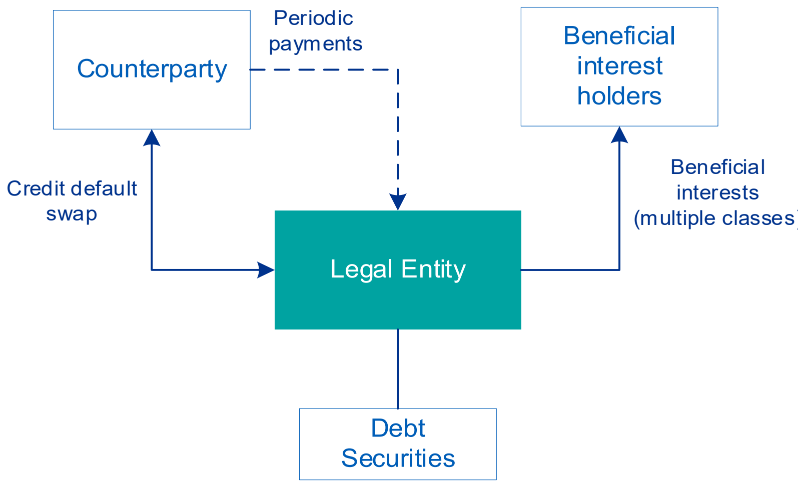
Under the terms of the credit default swap, Counterparty makes periodic premium payments to Legal Entity. In exchange, Legal Entity must do one of the following if a credit event occurs with respect to the underlying assets:

— purchase the underlying assets at par; or
— pay Counterparty the amount of the decrease in the fair value of the underlying assets.

Counterparty is senior in priority to any of Legal Entity's beneficial interest holders. If a credit event occurs with respect to the underlying assets, Legal Entity may be forced to sell its highly rated debt securities to make payments to

Counterparty. This may result in Legal Entity having insufficient cash flows to service principal and interest payments to the Beneficial Interests.

The credit default swap is a creator of variability (see Example 3.3.60).



Evaluation

Beneficial Interests are variable interests in Legal Entity because they each absorb some of the variability that Legal Entity was designed to create and distribute to its interest holders – i.e. credit risk of the underlying assets.

3.4.20 Derivatives and embedded derivatives

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

>>> Forward Contracts

55-27 Forward contracts to buy assets or to sell assets that are not owned by the VIE at a fixed price will usually expose the VIE to risks that will increase the VIE's expected variability. Thus, most forward contracts to buy assets or to sell assets that are not owned by the VIE are not variable interests in the VIE.

55-28 A forward contract to sell assets that are owned by the VIE at a fixed price will usually absorb the variability in the fair value of the asset that is the subject of the contract. Thus, most forward contracts to sell assets that are owned by the VIE are variable interests with respect to the related assets. Because forward contracts to sell assets that are owned by the VIE relate to specific assets of the VIE, it will be necessary to apply the guidance in paragraphs 810-10-25-55 through 25-56 to determine whether a forward contract to sell an asset owned by a VIE is a variable interest in the VIE as opposed to a variable interest in that specific asset.

>>> Other Derivative Instruments

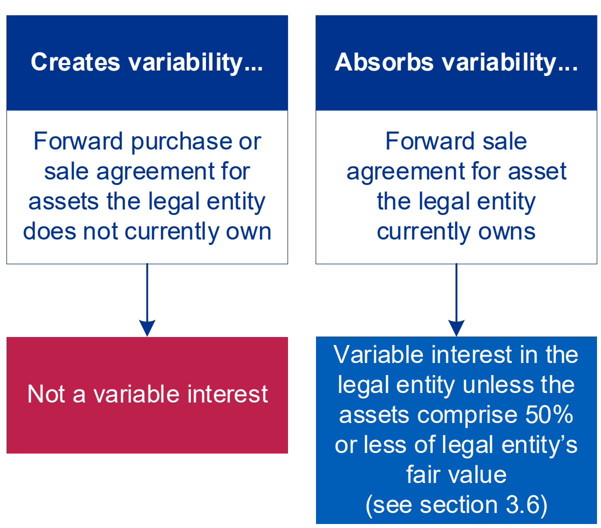
55-29 Derivative instruments held or written by a VIE shall be analyzed in terms of their option-like, forward-like, or other variable characteristics. If the instrument creates variability, in the sense that it exposes the VIE to risks that will increase expected variability, the instrument is not a variable interest. If the instrument absorbs or receives variability, in the sense that it reduces the exposure of the VIE to risks that cause variability, the instrument is a variable interest.

55-30 Derivatives, including total return swaps and similar arrangements, can be used to transfer substantially all of the risk or return (or both) related to certain assets of an VIE without actually transferring the assets. Derivative instruments with this characteristic shall be evaluated carefully.

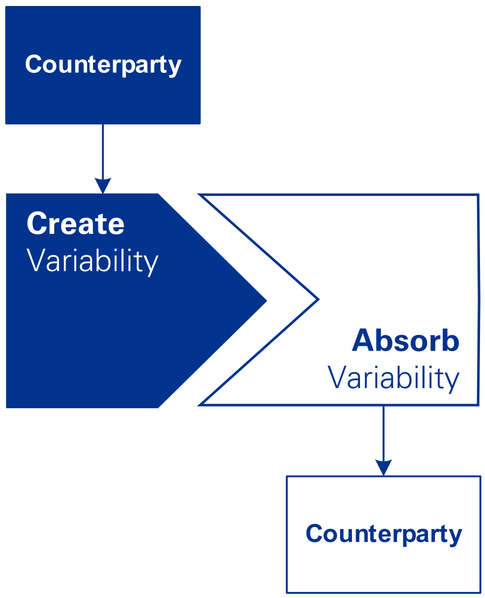
55-31 Some assets and liabilities of a VIE have embedded derivatives. For the purpose of identifying variable interests, an embedded derivative that is clearly and closely related economically to its asset or liability host is not to be evaluated separately.

The by-design approach requires an enterprise to understand the nature of the variability that a legal entity was designed to create and pass along to its interest holders when determining whether an interest is a variable interest. Although this principle applies equally to derivatives, Subtopic 810 provides creator characteristics that if present, generally indicate that a derivative is a creator (instead of an absorber) of variability in a legal entity (see section 3.3.40).

This section addresses how to evaluate derivatives that do not meet the creator characteristics. For example, forward contracts may create or absorb variability. [810-10-55-27 – 55-28]



Like forward contracts, any type of derivative that lacks the creator characteristics (section 3.3.40) may be a variable interest if it absorbs some of the variability that a legal entity was designed to create and pass along to its interest holders. Conversely, derivatives that expose the legal entity to risks that increase its expected variability are not variable interests. Derivatives that transfer substantially all of the risks associated with a certain asset should be carefully evaluated. [810-10-55-29 – 55-30]



An embedded derivative is evaluated as a variable interest separate from its host contract only if it is not clearly and closely related economically to that host. [810-10-55-31]

Question 3.4.50

What are some common derivatives and their typical roles as creators or absorbers of variability?

Interpretive response: The following diagram identifies common derivatives and indicates if they generally create or absorb variability. Derivative contracts that create variability in a legal entity are not variable interests. Those that absorb variability are variable interests if they absorb some of the variability that the legal entity was designed to create and pass along to its interest holders (see section 3.3).

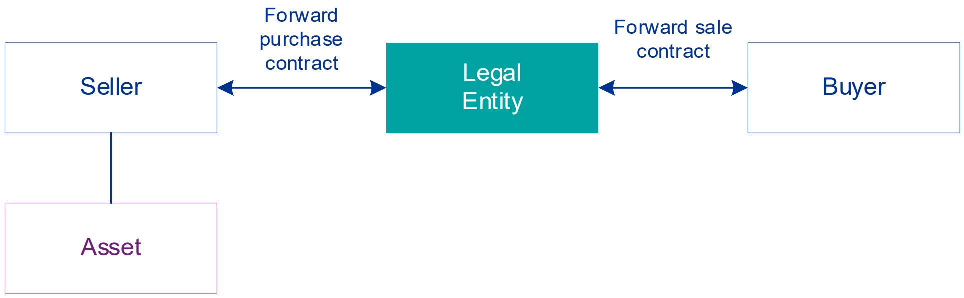
Written put or guarantee	The counterparty has the right to sell assets to the legal entity at a price other than their fair value or to receive protection against specified risks from the legal entity	**Creates** variability
Purchased put or guarantee	The legal entity has the right to sell assets to the counterparty at a price other than their fair value or to receive protection against specified risks from the counterparty	**Absorbs** variability
Written call	The counterparty has the right to purchase assets from the legal entity at a price other than their fair value	**Absorbs** variability
Purchased call	The legal entity has the right to purchase assets from the counterparty at a price other than their fair value	**Creates** variability
Forward purchase	The legal entity has agreed to purchase assets from the counterparty at a fixed price at a future date	**Creates** variability
Forward sale	The counterparty has agreed to purchase assets the legal entity currently owns at a fixed price at a future date	**Absorbs** variability
Total return swap (in)	The counterparty pays the total return related to a specific asset or asset group to the legal entity and the legal entity pays the counterparty a fixed return based on a notional amount	**Creates** variability
Total return swap (out)	The legal entity pays the total return related to a specific asset or asset group to the counterparty and the counterparty pays the legal entity a fixed return based on a notional amount	**Absorbs** variability
Interest rate swap (fixed for floating)	The legal entity pays interest to the counterparty based on a fixed rate and the counterparty pays interest to the legal entity based on a variable rate	**Creates** variability
Interest rate swap (floating for fixed)	The counterparty pays interest to the legal entity based on a fixed rate and the legal entity pays interest to the counterparty based on a variable rate	**Creates** variability

Example 3.4.50
Offsetting forward contracts

Background

Legal Entity has a forward contract with Seller to purchase an asset that it does not already own.

Legal Entity also has a separate forward contract with Buyer to sell the asset to be acquired under the forward purchase contract.



Evaluation

The forward purchase contract and the forward sale contract are evaluated separately (see Question 3.3.50).

Both contracts create variability in Legal Entity. Forward purchase contracts typically create variability, and the forward sale contract cannot absorb variability because Legal Entity does not own the referenced asset. Neither contract can be a variable interest in the Legal Entity or an interest in specified assets of Legal Entity (see section 3.6). [810-10-55-27]

Question 3.4.60
How is the variability absorbed by a forward contract computed?

Interpretive response: When a forward contract is a variable interest in a legal entity (not an interest in specified assets, see section 3.6), we believe that one acceptable method is for an enterprise to use a with-and-without approach to compute the variability absorbed.

Under a with-and-without approach, the enterprise computes the legal entity's total variability without the forward contract and compares it to the entity's total variability with it. The difference in those computations is the variability attributed to the forward contract.

Question 3.4.65**

Are power purchase agreements (PPAs) considered variable interests?

Interpretive response: It depends. The enterprise evaluates the PPA to determine if it absorbs or creates variability related to the risks the power plant entity was designed to create and distribute to its interest holders. Typical risks of a power plant entity may include:

— design and construction
— variability in fuel prices
— variability in power prices
— operations and maintenance risks
— ownership risks (e.g. residual value, decommissioning)
— production (output) risk
— other specific risks created by the contract.

PPAs that absorb variability associated with the above risks may be variable interests. [For example, a PPA for power generated by a fossil fuel-fired power plant may absorb the variability in the price of fuel (e.g. coal, natural gas) when the contract price includes a variable fuel price index or pass-through of fuel costs]. In contrast, a PPA with an overall fixed price per unit of power may not be a variable interest because it may create rather than absorb price risk (i.e. the seller is exposed to variability in fuel price risk). For other types of PPAs, entities should evaluate the facts and circumstances to determine if the contract creates or absorbs variability associated with the risks of the fossil fuel-fired power plant entity.

Unlike a fossil fuel-fired power plant, a renewable energy project (such as solar or wind farm) typically does not require fuel inputs and therefore does not create fuel price risk. Further, the design and technology of many renewable energy projects limit exposure to operations and maintenance risks. Typically, renewable energy projects are designed to distribute power price risk to its interest holders. The following are relevant considerations for renewable energy project PPAs.

— **Fixed-price PPA:** A PPA to purchase all power generated by a renewable energy project that has limited exposure to other risks would absorb power price risk and therefore be a variable interest.

— **Variable-price PPA:** A PPA indexed to the relevant power market price would typically create commodity price risk rather than absorb the risk and therefore not be a variable interest.

— **Fixed-price PPA with a production guarantee:** A fixed-price PPA containing terms requiring the renewable energy project to deliver a minimum quantity of power may absorb price risk but also create production risk. This type of PPA may be a variable interest depending on the level of risk created by the minimum production quantity compared to expected generation capacity of the renewable energy project.

See section 8 of KPMG Handbook, Climate risk in the financial statements, for additional guidance and risk considerations related to renewable energy PPAs.

Also, see section 3.4.40 for discussion of supply contracts that are accounted for as leases.

Example 3.4.55**

Renewable power purchase agreement

Buyer executes a fixed-price PPA with Seller, a renewable energy project entity, to purchase all of the power generated by Seller's solar farm for 15 years. The PPA does not contain a production guarantee or other provisions that require the Seller to deliver a specified quantity of power.

The solar farm is comprised of solar panels with high statistical energy yield confidence, established design and technology, and corresponding established operations and maintenance requirements. The terms of the PPA provide Seller with assurance of future cash inflows sufficient to collateralize the project entity's construction financing with a third-party lender.

The key risk the entity was designed to create and distribute is price risk because the entity's exposure to other risks is limited for the following reasons:

- high statistical energy yield limits production risk and the PPA contains no minimum production guarantees that may create such risk;
- established design and technology limits exposure to operations and maintenance risks; and
- the project entity's input requirements are limited to solar energy, therefore creating no input/fuel price risk.

Buyer concludes the PPA is a variable interest because the fixed pricing absorbs the price risk for all power generated during its term.

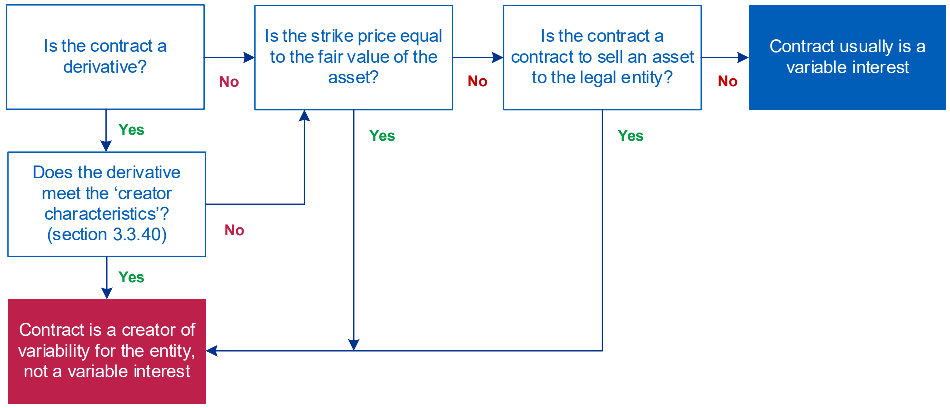
Question 3.4.70

When is a contract to purchase/sell an asset a variable interest in the legal entity that owns the asset?

Interpretive response: A contract to physically purchase or sell an asset usually is a variable interest in the legal entity that owns the asset if it: [810-10-55-28]

- includes a strike price that may differ from the fair value of the asset(s) at exercise; and
- represents an interest in the legal entity that will physically settle the contract instead of an interest in specified asset(s) (see section 3.6).

The following decision tree illustrates the steps to consider in determining if a purchase or sale contract is a variable interest. These scenarios assume the contract is an interest in the legal entity that owns the asset instead of an interest in specified assets (see section 3.6).



Contracts with a strike price that equals the fair value of the asset at exercise generally are not variable interests in the legal entity because they do not change the variability absorbed by the legal entity's other interest holders.

Question 3.4.80

Do fixed-price real estate purchase or sale contracts represent variable interests?

Interpretive response: It depends. We do not believe a fixed-price real estate purchase or sale contract represents a variable interest in the legal entity that owns the real estate if:

— there are substantive conditions that must be met before the transaction closes; or
— the purchaser has a substantive right to terminate the contract.

A purchase or sale contract is also not a variable interest in the legal entity that owns the asset if it is an interest in specified assets (see section 3.6).

Substantive conditions precedent to closing

We believe the following conditions precedent to closing may qualify as substantive.

— The existing lender is required to consent to the transfer of the property and the buyer's assumption of the existing loan and consent has not been obtained.

— The seller must meet title transfer requirements that have not yet been completed.

— There are contract or other violations that must be remedied before closing and those remedial actions have not been taken.

— The seller must obtain estoppel certificates and has not done so.

— A material casualty to the property before closing would terminate the contract.

— The seller retains the risk of loss in the event of a material casualty occurring before the closing date.

— Representations and warranties of the seller have been breached.

Substantive right to terminate the contract

If the purchaser has a substantive right to terminate the contract prior to closing and receive a return of the escrow deposit, the contract is similar to a contingent forward contract, which we believe is generally not a variable interest. The contingency created by the substantive right to terminate prior to closing protects the purchaser from absorbing any of the seller's risks, and therefore its variability.

Without a substantive termination clause, the purchaser is exposed to risks of the seller prior to closing, and therefore the contract generally is an absorber of variability.

Question 3.4.85

Do supply contracts represent variable interests in the supplier?

Interpretive response: It depends. The purchaser needs to evaluate the design of the legal entity (i.e. the supplier) and the nature of the variability that the legal entity was designed to create and pass along to its interest holders. If the contract is a derivative, the purchaser considers the guidance in section 3.3.40.

A supply contract to purchase assets currently owned by the supplier is evaluated consistently with purchase contracts, as discussed in Question 3.4.70. However, in many supply contracts, the supplier may not own some or all of the assets that it will be selling because they will be manufactured or procured after contract inception. In those cases, consideration of the design of the supplier and contract terms is important in evaluating whether the contract absorbs the risks of the supplier.

The following are examples of considerations for different types of contracts:

— A fixed-price contract to purchase assets not yet owned by the supplier typically creates variability and therefore is not a variable interest. [810-10-55-27]

— A variable-priced contract may be a variable interest if the pricing absorbs risks that the supplier was designed to create from the residual interests – e.g. a cost reimbursable contract to purchase all of the supplier's output may absorb the operations and material price risk by reimbursing all of the supplier's costs.

— An off-market contract may be a variable interest if the contract absorbs variability by reallocating expected losses to the purchaser or if the off-market rate is effectively providing financing to the supplier.

Section 3.4.40 discusses supply contracts that are accounted for as leases.

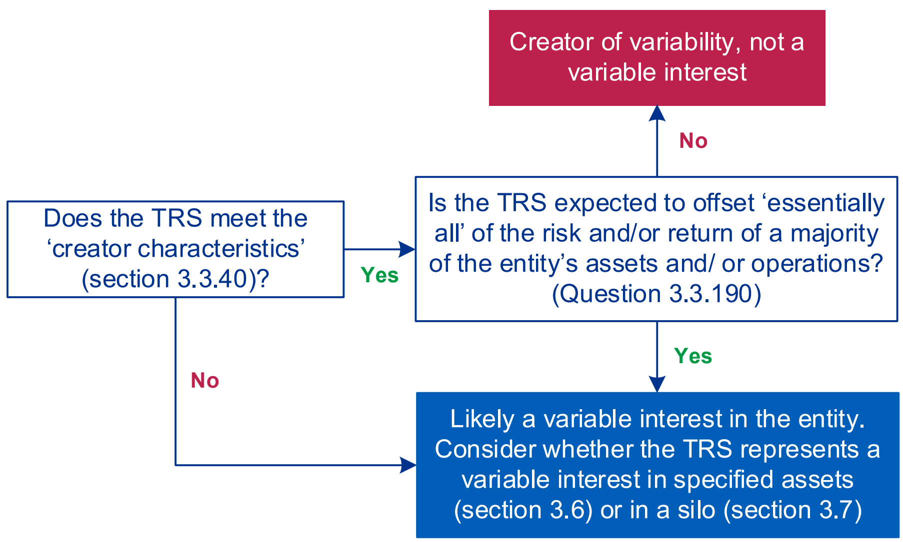
Question 3.4.90

How does an enterprise evaluate whether a TRS (or similar arrangement) represents a variable interest?

Interpretive response: Understanding the design of the legal entity is important when determining whether a TRS represents a variable interest in that entity. [810-10-55-30]

A TRS is a derivative that allows one entity to transfer the risks and benefits related to a specific asset or group of assets (the 'reference assets') to another entity without transferring the assets. As discussed in section 3.3.40, if the creator characteristics are met, the TRS typically does not represent a variable interest in the legal entity that owns the reference assets.

The following decision tree is helpful in evaluating whether a TRS is a variable interest in the legal entity that holds the reference assets.



Consider whether the TRS represents a variable interest in the legal entity

If the fair value of the reference assets to which the TRS relates comprises a majority of the fair value of the legal entity's assets, the TRS is an interest in the legal entity itself, and likely a variable interest. A TRS that is expected to offset essentially all of the risks/returns from a majority of the legal entity's assets or operations generally represents a variable interest in the legal entity itself.

If the fair value of the reference asset(s) to which the TRS relates comprises less than a majority of the fair value of the legal entity's assets (i.e. 50% or less), the TRS is an interest in specified assets (see section 3.6). An interest in specified assets is not an interest in the legal entity itself, and therefore not a variable interest. [810-10-55-30]

Consider whether the TRS represents a variable interest in a silo VIE

The presence of a TRS does not necessarily create a potential silo (see section 3.7). However, it may represent a variable interest in a potential silo if the reference assets are the only payment source for the obligations created by the TRS.

If the TRS is a silo VIE, the enterprise applies the creator characteristics and the essentially all test as if the silo VIE were a separate VIE (see section 3.3.40). For example, when performing the essentially all test, an enterprise compares the changes in the fair value or cash flows of the TRS to the risk/return from the majority of the silo VIE's assets. See section 3.7 for further discussion on silos.

Example 3.4.60
TRS: variable interest in legal entity

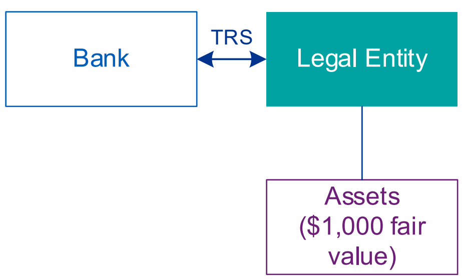
Background

Legal Entity owns debt securities with a fair value of $750, all of which bear interest at 5% per year and mature in five years. Legal Entity's total assets have a fair value of $1,000.

Legal Entity enters into a TRS with Bank. Under the swap's terms:

— Legal Entity receives from Bank periodic variable payments equal to one-year SOFR plus 75 bps times the par amount of the debt securities; and
— Bank receives from Legal Entity the total return generated by the debt securities.

Bank is senior in priority to the other interest holders in Legal Entity and has recourse to Legal Entity's assets in the event of default.



Evaluation

Bank has a variable interest in Legal Entity itself because the reference assets underlying the TRS comprise a majority of the fair value of Legal Entity's assets. Further, the debt securities and the TRS are not a potential silo – Bank has recourse to Legal Entity's other assets in the event of default.

Example 3.4.70
TRS: variable interest in silo VIE

Background

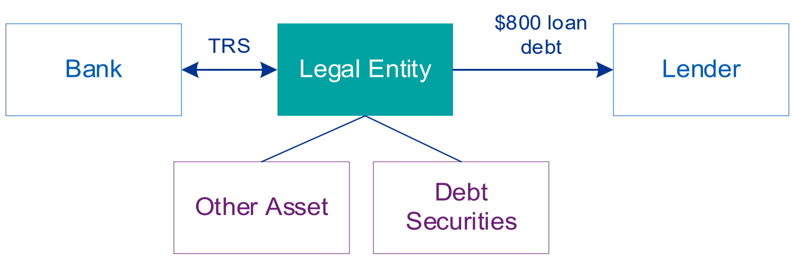
Legal Entity borrows $800 on a nonrecourse basis from Lender to fund the purchase of $800 of debt securities. Legal Entity's total assets have a fair value of $1,000.

Legal Entity must pay Lender interest on the nonrecourse loan at a rate of three-month SOFR plus 75 bps.

Legal Entity enters into a TRS with Bank. Under the swap's terms:

— Legal Entity receives from Bank periodic variable payments equal to three-month SOFR plus 75 bps times the par amount of the debt securities; and
— Bank receives from Legal Entity the total return generated by the debt securities.

Bank is senior in priority to the other interest holders in Legal Entity (a VIE).



Evaluation

Bank has a variable interest in the silo VIE comprised of the debt securities and the nonrecourse debt. A silo VIE exists because:

— the returns of the debt securities are Bank's sole source of payment; and

— the variability of the silo VIE's assets would be absorbed entirely by Bank and Lender – i.e. the change in the fair value of the debt securities would be absorbed entirely by the TRS and nonrecourse loan.

Question 3.4.100
When are an embedded derivative and its host clearly and closely related economically'?

Interpretive response: An embedded derivative is evaluated as a variable interest separate from its host contract only if it is not clearly and closely related economically to the host. We believe that an embedded derivative and its host contract likely are clearly and closely related economically if all of the following conditions are met.

— The embedded derivative and the host share a common **underlying**.
— The changes in fair value of the embedded derivative are **proportional** to the changes in fair value of the host contract.

- The changes in fair value of the embedded derivative are **highly correlated** with the changes in fair value of the host contract.

This evaluation requires careful consideration of all relevant facts and circumstances.

- **Underlying.** An underlying is any variable factor (usually a price or index) that, along with either a notional amount or a payment provision, determines the settlement of an instrument or the anticipated proceeds. As a result, the fair value of an instrument generally changes with changes in one or more underlyings. [815-10 Glossary]
- **Proportional.** If the magnitude of an embedded derivative's fair value change is significantly bigger or smaller than the magnitude of the host contract's fair value change when the common underlying changes, those changes are not proportional. This may occur if the terms of the embedded derivative (or the host) include a leverage factor. A leverage factor serves to increase an instrument's exposure to the underlying. For example, the fair values of a host contract with a US Treasury rate underlying and an embedded feature that settles based on 2x the US Treasury rate will not change proportionally.
- **Highly correlated.** An embedded derivative and host contract meet the highly correlated condition if their fair values show direct or inverse correlation when the common underlying changes.

Similarity to Topic 815

Topic 815 (derivatives and hedging) contains bifurcation guidance, including determining whether an embedded derivative is clearly and closely related to its host. This guidance generally is consistent with the guidance in Subtopic 810-10. [815-15-25-1, 810-10-55-31]

However, Topic 815 does not always require separation of an embedded derivative that is not clearly and closely related to its host. As a result, there may be embedded derivatives that are not clearly and closely related, but also are not accounted for separately under Topic 815.

Although Topic 815 can be helpful when evaluating whether an embedded feature must be evaluated separately as a potential variable interest, an enterprise should not exclusively rely on the bifurcation analysis.

Question 3.4.110

What are some common embedded derivatives and their typical economic relationship with the host?

Interpretive response: The following table identifies common embedded derivatives within various host contracts and a brief discussion about whether they are clearly and closely related economically. See also the related discussion in Question 3.4.100.

Embedded feature(s)	Host contract	Evaluating clearly and closely related economically
Call and put features	Equity instrument	Embedded call and put features that require the legal entity to purchase the instrument at a price other than its fair value or give the holder the right to require the entity to purchase the instrument at a price other than its fair value are generally not clearly and closely related economically to the equity host. This is because the economic characteristics of put and call features differ from those of an equity instrument.
Call and put features	Debt instrument	Embedded call and put features in a debt host are generally considered clearly and closely related economically to the debt host unless one of the following conditions is met: — the debt has a substantial discount or premium (e.g. a zero-coupon bond) after considering the effect of the strike price of the call or put, and the embedded feature is contingently exercisable; or — the call or put feature is not contingently exercisable but: – there are contractual settlement provisions that may result in the investor failing to recover substantially all its recorded investment; and – the feature could at least double the investor's initial rate of return on the debt host and result in a rate of return that is at least twice the then-current market rate of return for the debt host.
Interest rate/interest rate index	Debt instrument	Embedded features based on an interest rate or interest rate index are generally considered clearly and closely related economically to the debt host if (1) significant leverage is not involved and (2) the debt cannot be settled so that the investor would not recover substantially all of its investment.
Other interest rate features (collars, floors and caps)	Debt instrument	Embedded collars, floors and caps are generally considered clearly and closely related economically to the debt host provided that (1) no leverage exists and (2) the floor is below and the cap is above the market interest rate at the date of issuance.
Credit sensitive payment features	Debt instrument	A debtor's creditworthiness and the interest rate on its debt issuances are clearly and closely related. Therefore, features within debt instruments that change the interest rate paid upon a debtor-specific credit event (e.g. credit rating change, event of default) generally would be considered clearly and closely related economically to the debt host.

Embedded feature(s)	Host contract	Evaluating clearly and closely related economically
Inflation adjustment features	Debt instrument	Because interest rates and inflation rates in the economy from which the debt has been issued are clearly and closely related economically, embedded inflation-indexed provisions are generally considered clearly and closely related economically to the debt host provided that no leverage factor exists.
Equity or commodity-indexed features	Debt instrument	Embedded features that change the interest rate paid by the debtor based on changes in the fair value of an equity security, specific commodity, or index thereof are generally not considered clearly and closely related economically to the debt host.
Equity conversion features	Debt instrument	Embedded features that may permit or require conversion into an equity interest are generally not considered clearly and closely related economically to the debt host.
Residual value guarantees	Lease	Residual value guarantees are features embedded in leases that require the lessee to pay the lessor a specified amount if the underlying asset is worth less than a predetermined amount at a future date. Subtopic 810-10 requires that these features be considered **not** clearly and closely related economically to the lease host (see section 3.4.40). [810-10-55-78 – 55-80]
Purchase options	Lease	Embedded purchase options exercisable at a fixed price generally provide the lessee with the right to purchase the leased asset from the lessor at a specified date in the future. Subtopic 810-10 requires that these features be considered **not** clearly and closely related economically to the lease host (see section 3.4.40). [810-10-55-78 – 55-80]
Term-extending features	Lease	Unless the embedded term-extending features are based on market rates, such features are generally not considered clearly and closely related economically to the lease host. This is because they are not economically related to changes in value of the leased asset.
Inflation-indexed features	Lease	Unless significant leverage is involved, inflation-indexed rental features are generally considered clearly and closely related economically to the lease host.
Contingent rental payment features	Lease	Embedded features that require the lessee to make additional rental payments based on lessee sales or changes in a variable interest rate (e.g. SOFR) are generally considered clearly and closely related economically to the lease host.

3.4.30 Assets, guarantees and similar instruments

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

>>> Assets of the Entity

55-32 Assets held by a VIE almost always create variability and, thus, are not variable interests. However, as discussed separately in this Subsection, assets of the VIE that take the form of derivatives, guarantees, or other similar contracts may be variable interests.

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

>>> Guarantees, Written Put Options, and Similar Obligations

55-25 Guarantees of the value of the assets or liabilities of a VIE, written put options on the assets of the VIE, or similar obligations such as some liquidity commitments or agreements (explicit or implicit) to replace impaired assets held by the VIE are variable interests if they protect holders of other interests from suffering losses. To the extent the counterparties of guarantees, written put options, or similar arrangements will be called on to perform in the event expected losses occur, those arrangements are variable interests, including fees or premiums to be paid to those counterparties. The size of the premium or fee required by the counterparty to such an arrangement is one indication of the amount of risk expected to be absorbed by that counterparty.

55-26 If the VIE is the writer of a guarantee, written put option, or similar arrangement, the items usually would create variability. Thus, those items usually will not be a variable interest of the VIE (but may be a variable interest in the counterparty).

Assets of an entity almost always create instead of absorb or receive variability of the entity, and therefore typically are not variable interests. However, assets that take the form of forward contracts, derivatives, guarantees or similar contracts may be variable interests. Further, assets of an entity that are not variable interests in the entity may have embedded features that are variable interests in the entity. See section 3.4.20 for additional discussion on derivatives. [810-10-55-32]

Guarantees, written put options and similar interests (e.g. insurance contracts) often protect a legal entity's senior variable interest holders from incurring economic losses. As a result, these contracts are variable interests if they absorb the variability that the entity was designed to create and distribute to its interest holders.

Conversely, when an enterprise is serving as a guarantor for another legal entity, the guarantee would be a creator of variability in the legal entity, and therefore not a variable interest in the legal entity. [810-10-55-25 – 55-26]

Question 3.4.120

What factors does an enterprise consider when evaluating whether a financial guarantee is a variable interest in the guaranteed entity?

Interpretive response: Financial guarantors should first evaluate if the guarantee relates to the guaranteed entity's specified assets or to the guaranteed entity as a whole.

If the guarantee relates to specified assets and the specified assets represent less than 50% of the fair value of the guaranteed entity's total assets, the guarantee is an interest in specified assets and not an interest (or variable interest) in the guaranteed entity itself (see section 3.6).

If the guarantee relates to specified assets and those assets comprise more than 50% of the total fair value of the guaranteed entity's total assets, the guarantee is an interest in the guaranteed entity itself. The guarantee is a variable interest in the guaranteed entity if it absorbs some of the variability that the guaranteed entity was designed to create and distribute to its interest holders (see section 3.3).

Financial guarantee arrangements are typically structured so that the guarantor absorbs the guaranteed entity's credit-related variability – i.e. they are usually not limited to absorbing risk specific to an entity's assets. As a result, the guarantor generally has a variable interest in the guaranteed entity.

Fees or premiums paid by the guaranteed entity under guarantees that are variable interests in the entity are excluded when computing the entity's expected losses and expected residual returns because those computations exclude the effects of variable interests (see chapter 10).

3.4.40 Operating leases

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

>>> Operating Leases

55-39 Receivables under an operating lease are assets of the lessor entity and provide returns to the lessor entity with respect to the leased property during that portion of the asset's life that is covered by the lease. Most operating leases do not absorb variability in the fair value of a VIE's net assets because they are a component of that variability. Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices may be variable interests in the lessor entity if they meet the conditions described in paragraphs 810-10-25-55 through 25-56. Alternatively, such arrangements may be variable interests in portions of a VIE as described in paragraph 810-10-25-57. The guidance in paragraphs 810-10-55-23 through 55-24 related to debt instruments applies to creditors of lessor entities.

Most operating leases do not absorb variability and are therefore not considered variable interests in the lessor. Conversely, finance leases generally do absorb variability and will give rise to a variable interest in the lessor entity if the fair value of the leased asset is more than 50% of the fair value of the lessor entity's assets (see section 3.6).

However, operating leases that include off-market terms, residual value guarantees or fixed-price purchase options may be a variable interest in the lessor entity or may be an interest in a silo VIE (see section 3.7). [810-10-55-39]

Question 3.4.130

How does a lessee with a plain vanilla operating lease evaluate whether it has a variable interest in the lessor?

Interpretive response: An operating lease is not a variable interest in the lessor if it is a plain vanilla operating lease. A 'plain vanilla' operating lease does not contain any of the following: [810-10-55-39]

— purchase options at a price that could differ from the fair value of the property on exercise of the option;
— residual value guarantees; or
— renewal options at rates that could differ from market rents on exercise of the option.

We do not believe the TRS guidance in Subtopic 810-10 applies to plain vanilla operating leases (see Question 3.4.90). As a result, even if the lease is expected to offset essentially all of the risk/return of a majority of the lessor's assets, a plain vanilla operating lease would not represent a variable interest in the lessor.

Implicit variable interests are more likely to arise in operating leases with a related party (see section 3.5).

Question 3.4.140

Does a lessee evaluate a residual value guarantee (or purchase option) in an operating lease separately from the lease contract?

Interpretive response: Yes. A lessee evaluates a residual value guarantee (and/or a purchase option) in an operating lease separately from the underlying lease. A fixed-price purchase (call) option or residual value guarantee may be a variable interest in the lessor entity or may be an interest in specified assets (see section 3.6). [810-10-55-39]

The guidance in Subtopic 810-10 on these features in lease contracts differs from:

— the guidance on accounting for leases. The parties to a lease generally apply the guidance in Topic 842 (leases) to the lease component as a single unit of account, even if it includes a residual value guarantee and/or a purchase option;

— the general principle in Subtopic 810-10 that a host contract and its embedded features are evaluated as a single unit of account if they are clearly and closely related economically (see section 3.4.20).

A lessee may also need to evaluate other embedded features in operating leases separately from the lease – e.g. renewal options and term-extending features. Those features are evaluated separately when they are not clearly and closely related economically to the host lease contract (see Question 3.4.110).

Question 3.4.150

How does a lessee with an operating lease that is not plain vanilla evaluate whether it has a variable interest in the lessor?

Interpretive response: A lessee in an operating lease that is not plain vanilla will need to carefully evaluate the lease terms to determine whether it absorbs some of the variability of the lessor entity (see Question 3.4.100). [810-10-55-39]

The following features may result in the lessee having a variable interest in the lessor; see section 3.3.50 for examples from Subtopic 810-10. [810-10-55-78 – 55-80]

Purchase options

An option that provides the lessee with the right to purchase the leased asset at fair value is generally not a variable interest.

However, an option that provides the lessee with the right to purchase the leased asset at a fixed price (or at a price derived by a formula) absorbs some of the lessor's variability and therefore generally is a variable interest.

However, if the purchase option relates to leased assets that comprise less than 50% of the fair value of the lessor's assets and the lessee has only an insignificant other interest in the lessor entity, it is not a variable interest in the lessor. Instead, it is an interest in specified assets (see section 3.6) and may be an interest in a silo VIE (see section 3.7).

Residual value guarantees

A residual value guarantee is a feature embedded in a lease that requires the lessee to pay the lessor a specified amount at a future date if the leased asset is worth less than a predetermined amount. This feature reduces the exposure to the risk of a decline in the leased asset's value that would otherwise be borne by the lessor's interest holders. As a result, these features generally are variable interests in the lessor.

However, if the residual value guarantee relates to assets that comprise less than 50% of the fair value of the lessor's assets, it is not a variable interest in the lessor. Instead, it is an interest in specified assets (see section 3.6) and may be an interest in a silo VIE (section 3.7).

Renewal options and term-extending features

Some embedded renewal options or other term-extending features allow the lessee to renew or extend the terms of the lease at an amount other than fair value on exercise. These features are generally not considered clearly and closely related economically to the lease host and therefore must be evaluated separately from the lease contract (see section 3.4.20). Fixed-price renewals or term-extending features absorb some of the lessor's variability from the leased asset and are generally considered variable interests in the lessor.

However, if the renewal option or term-extending feature relates to assets that comprise less than 50% of the fair value of the lessor's assets, it is an interest in specified assets and not a variable interest in the lessor (see section 3.6).

Question 3.4.160

Is prepaid rent a variable interest in the lessor entity?

Interpretive response: No. Prepaid rent generally does not represent a variable interest in the lessor. We believe lease payments required under an operating lease create variability for the lessor, regardless of when they are paid.

Question 3.4.170

How does a lessor evaluate whether an operating lease is a variable interest in the lessee?

Interpretive response: We believe an operating lease is generally not a variable interest in the lessee unless the fair value of the leased asset exceeds the total fair value of the lessee's other assets.

However, there may be other circumstances in which the lessee has been designed to create and distribute credit risk to the lessor. This is more likely to occur when the lessor has other interests in the lessee that absorb more than an insignificant amount the lessee's variability (e.g. an equity interest). All relevant facts and circumstances should be considered.

3.4.50 Variable interest of one VIE in another VIE

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

>>> Variable Interest of One VIE in Another VIE

55-40 One VIE is the primary beneficiary of another VIE if it meets the conditions in paragraph 810-10-25-38A. A VIE that is the primary beneficiary of a second VIE will consolidate that second VIE. If another reporting entity consolidates the first VIE, that reporting entity's consolidated financial statements include the second VIE because the second VIE had already been consolidated by the first. For example, if Entity A (a VIE) is the primary beneficiary of Entity B (a VIE), Entity A consolidates Entity B. If Entity C is the primary beneficiary of Entity A, Entity C consolidates Entity A, and Entity C's consolidated financial statements include Entity B because Entity A has consolidated Entity B.

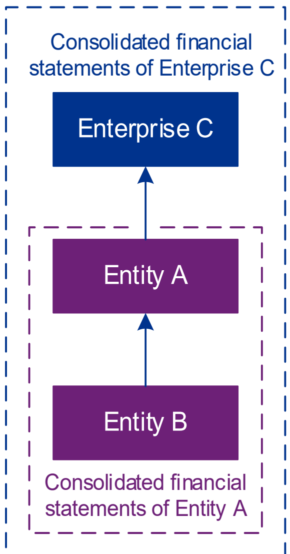
55-41 A transferor's interests in financial assets in a VIE is a variable interest in the transferee entity but it is not a variable interest in a second VIE to which the transferee issues a beneficial interest. The following illustrates this point:

a. Entity A transfers financial assets to VIE B (a VIE that holds no other assets), retains a subordinated beneficial interest, and reports the transfer as a sale under the provisions of Topic 860.
b. VIE B issues all of its senior beneficial interests in the transferred assets to VIE C. VIE C issues various types of interests in return for cash and uses the cash to pay VIE B. VIE B uses the cash received from VIE C to pay Entity A.
c. Entity A's subordinated beneficial interest is a variable interest in VIE B, but neither VIE B nor Entity A has a variable interest in VIE C.

When a parent consolidates a subsidiary, it reports its financial position and results of operations on a combined basis with the subsidiary. If the subsidiary is also a parent – i.e. the subsidiary has its own consolidated subsidiary (a downstream subsidiary) – the parent also reports that downstream subsidiary on a combined basis.

A parent's explicit variable interests are those that it holds directly in its subsidiaries. Variable interests held by those subsidiaries in downstream subsidiaries are not explicit variable interests of the parent. Therefore, a parent enterprise may ultimately consolidate legal entities in which it does not hold an explicit variable interest. [810-10-55-40 – 55-41]

For example, in the following diagram, Enterprise C does not hold a direct variable interest in Entity B but will still consolidate it through its controlling financial interest in Entity A.



Question 3.4.180

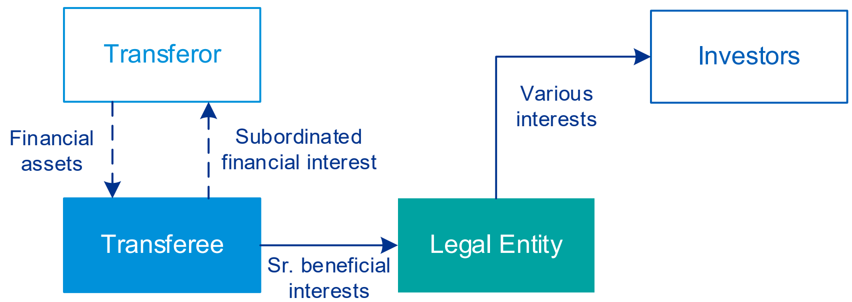
Does a transferor that has a beneficial interest in the transferred financial assets have a variable interest in the transferee's other beneficial interest holders?

Interpretive response: Generally, no. When an enterprise (transferor) transfers financial assets to a legal entity (transferee) in exchange for beneficial interests, it: [810-10-55-41]

- has a variable interest in the transferee to which the financial assets were transferred; but
- does not have a variable interest in the transferee's other beneficial interest holders.

The exception to this principle is a situation in which the transferor has an implicit interest in the other beneficial holders. An implicit variable interest is exposed to a legal entity's variability like an explicit interest but the exposure is indirect or implied (see section 3.5). Implicit variable interests are more often present in transactions that involve related parties.

The following diagram illustrates an example structure.



In this example, Transferor has a variable interest in Transferee but does not have a variable interest in Legal Entity – unless other circumstances suggest that Transferor has an implied variable interest.

Transferor does not look through Transferee – i.e. it does not conclude that it absorbs Legal Entity's expected losses through its subordinated beneficial interest in Transferee. Investors absorb Legal Entity's variability – i.e. the variability created by Legal Entity's investment in the senior beneficial interests of Transferee.

3.5 Implicit interests

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

>> Implicit Variable Interests

25-49 The following guidance addresses whether a reporting entity should consider whether it holds an implicit variable interest in a VIE or potential VIE if specific conditions exist.

25-50 The identification of variable interests (implicit and explicit) may affect the following:

a. The determination as to whether the potential VIE shall be considered a VIE
b. The calculation of expected losses and residual returns
c. The determination as to which party, if any, is the primary beneficiary of the VIE.

Thus, identifying whether a reporting entity holds a variable interest in a VIE or potential VIE is necessary to apply the provisions of the guidance in the Variable Interest Entities Subsections.

25-51 An implicit variable interest is an implied pecuniary interest in a VIE that changes with changes in the fair value of the VIE's net assets exclusive of variable interests. Implicit variable interests may arise from transactions with related parties, as well as from transactions with unrelated parties.

25-52 The identification of explicit variable interests involves determining which contractual, ownership, or other pecuniary interests in a legal entity directly absorb or receive the variability of the legal entity. An implicit variable interest acts the same as an explicit variable interest except it involves the absorbing and (or) receiving of variability indirectly from the legal entity, rather than directly from the legal entity. Therefore, the identification of an implicit variable interest involves determining whether a reporting entity may be indirectly absorbing or receiving the variability of the legal entity. The determination of whether an implicit variable interest exists is a matter of judgment that depends on the relevant facts and circumstances. For example, an implicit variable interest may exist if the reporting entity can be required to protect a variable interest holder in a legal entity from absorbing losses incurred by the legal entity.

25-53 The significance of a reporting entity's involvement or interest shall not be considered in determining whether the reporting entity holds an implicit variable interest in the legal entity. There are transactions in which a reporting entity has an interest in, or other involvement with, a VIE or potential VIE that is not considered a variable interest, and the reporting entity's related party holds a variable interest in the same VIE or potential VIE. A reporting entity's interest in, or other pecuniary involvement with, a VIE may take many different forms such as a lessee under a leasing arrangement or a party to a supply contract, service contract, or derivative contract.

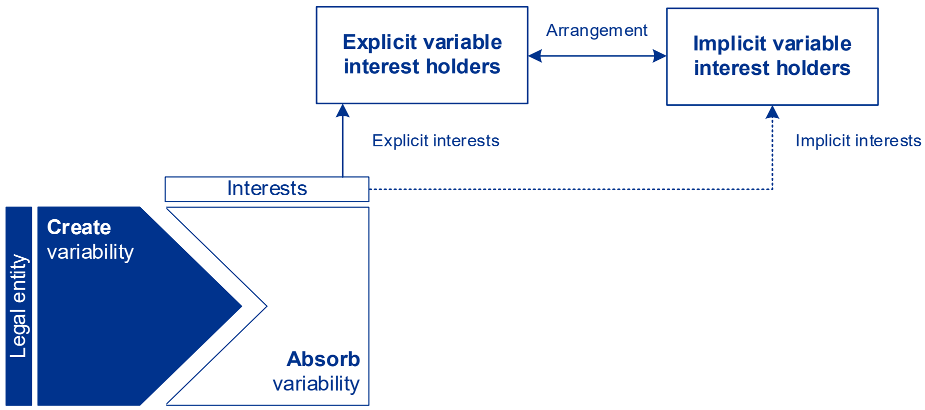
25-54 The reporting entity shall consider whether it holds an implicit variable interest in the VIE or potential VIE. The determination of whether an implicit variable interest exists shall be based on all facts and circumstances in determining whether the reporting entity may absorb variability of the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

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

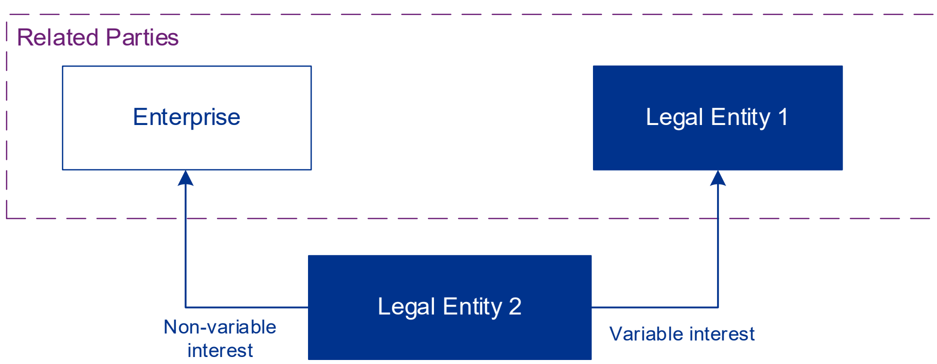
Section 3.4 addresses explicit interests – i.e. those interests that may directly absorb or receive the variability of the legal entity.

There may be other interests in a legal entity that indirectly expose the holder to that same variability – i.e. implicit variable interests. Whether a variable interest is explicit or implicit, the by-design analysis is the same (see section 3.3). An explicit or implicit interest is a variable interest of the holder if it absorbs some of the variability that the legal entity was designed to create and distribute to its interest holders. [810-10-25-50 – 25-52]

An enterprise may have an implicit variable interest in a legal entity through a contract that it arranges with a direct variable interest holder in the legal entity as shown in the following diagram. It may also have an implicit variable interest in legal entity through a noncontractual arrangement with a variable interest holder. [810-10-25-54]



Implicit variable interests commonly arise in leasing and other arrangements involving related parties. The existence of related party relationships can significantly affect the analysis of whether a legal entity is a VIE (see chapter 4) and who consolidates the VIE (see chapter 6). As a result, an enterprise should evaluate whether it has an implicit variable interest in a legal entity in which a related party has an explicit interest as shown the following diagram. This evaluation should be done even if the enterprise believes its possible implicit variable interest in a legal entity is quantitatively minor. [810-10-25-53]



Implicit variable interests also may arise in arrangements with unrelated parties. [810-10-25-51]

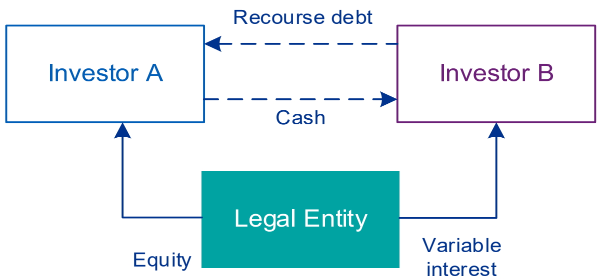
Contractual variable interests

Question 3.5.10

Can a contract outside the legal entity create an implicit variable interest?

Interpretive response: Yes. An implicit variable interest is an interest that participates in the economic risks and/or rewards of a legal entity but does so indirectly. An enterprise may have an implicit variable interest in a legal entity through a contract that it arranges with a direct variable interest holder in the legal entity. [810-10-25-51 – 25-52]

The SEC staff addressed in a speech (see below) how activities outside the entity may affect identifying implicit variable interests. The following diagram illustrates the SEC staff's scenario. [2004 AICPA Conf]



Excerpt from SEC staff speech

We have seen a number of questions about whether certain aspects of a relationship that a variable interest holder has with a variable interest entity (VIE) need to be considered when analyzing the application of [the VIE guidance in ASC Subtopic 810-10]. These aspects of a relationship are sometimes referred to as "activities around the entity". It might be helpful to consider a simple example. 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 [the VIE guidance in ASC Subtopic 810-10]. The short answer is no. First, [the VIE guidance in ASC Subtopic 810-10] specifically requires you to consider loans between investors as well as those between the entity and the enterprise in determining whether equity investments are at risk,[1] and whether the at risk holders possess the characteristics of a controlling financial interest as defined in [ASC paragraph 810-10-15-14(b)].[2] 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 "activities around the entity" that should be considered when applying [the VIE guidance in ASC Subtopic 810-10] include equity investments between investors, puts and calls between the enterprise and other investors and non-investors, service arrangements with investors and non-investors, and derivatives such as total return swaps. There may be other activities around the entity that need to be considered, which I have not specifically mentioned. These activities can impact the entire analysis under [the VIE guidance in ASC Subtopic 810-10] including the assessment of whether an entity is a VIE as well as who is the primary beneficiary.

In another situation involving activities around the entity, investors became involved with an entity because of the availability of tax credits generated from the entity's business. Through an arrangement around the entity, the majority of the tax credits were likely to be available to one specific investor. Accordingly, the staff objected to an analysis by this investor that 1) did not include the tax credits as a component of the investor's variable interest in the entity and 2) did not consider the impact of the tax credits and other activities around the entity on the expected loss and expected residual return analysis.

Jane D. Poulin, Remarks before the 2004 AICPA National Conference on SEC and PCAOB Developments

1 FIN 46R, paragraph 5(a)(4) [ASC paragraph 810-10-15-14(a)(4)].
2 FIN 46R, paragraph 5(b) [ASC paragraph 810-10-15-14(b)].

Example 3.5.10
Implicit variable interest through a TRS

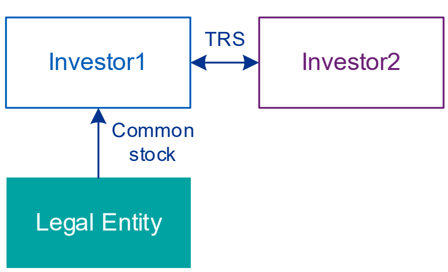
Background

Investor1 purchases common stock that represents a variable interest in Legal Entity.

Investor1 enters into a TRS with Investor2 with the following terms.

— Investor1 pays to Investor2 all returns it receives from its common stock investment – e.g. dividends, capital appreciation.
— Investor2 pays Investor1 a fixed return plus declines in the fair value of the common stock.

Cash flows under the TRS are settled on specified dates, including on maturity of the TRS. Investor1 and Investor2 are not related parties.



Evaluation

Investor2 has an implicit variable interest in Legal Entity. Although it does not directly own common shares issued by Legal Entity, the TRS is structured to transfer Legal Entity's variability from Investor1 to Investor2.

If Investor2 had executed the TRS with Legal Entity directly, Investor2 would have an explicit variable interest in Legal Entity because it is expected to offset essentially all of the risks and returns of a majority of Legal Entity's assets (see Question 3.4.90).

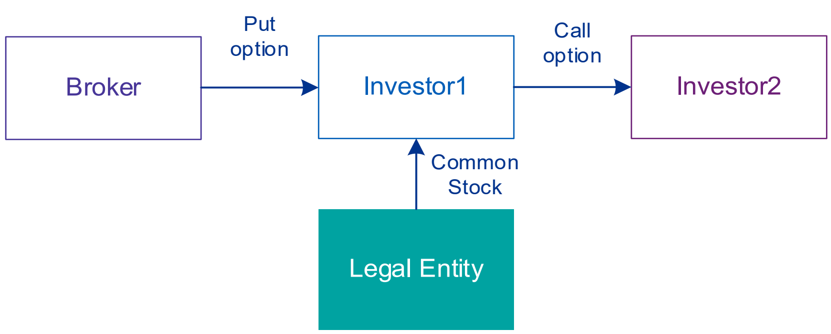
Example 3.5.20
Implicit variable interest through a call or put option

Background

Investor1 purchases common stock that represents a variable interest in Legal Entity.

Investor1 writes a call option to Investor2 (an unrelated third party) that allows Investor2 to purchase the common stock at a predetermined price. Investor1 and Investor2 are not related parties.

Investor1 purchases a put option from Broker that allows Investor1 to sell the common stock at a predetermined price. Investor1 and Broker are not related parties.



Evaluation

Investor2 and Broker have implicit variable interests in Legal Entity.

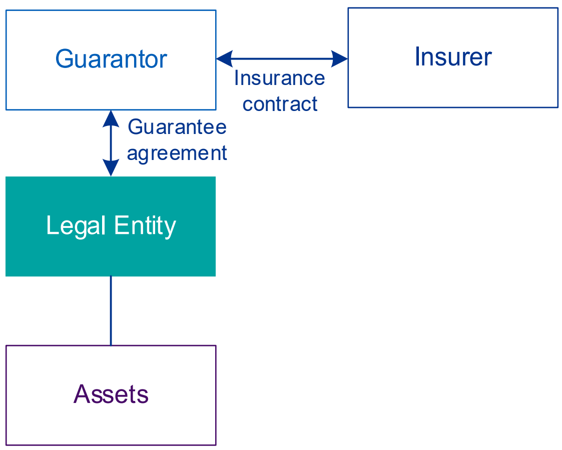
Although Investor2 and Broker do not directly own common shares issued by Legal Entity, they absorb Legal Entity's variability through the call and put options.

Example 3.5.30
Implicit variable interest through an asset guarantee arrangement

Background

Guarantor guarantees the value of greater than 50% of the assets owned by Legal Entity and therefore has a variable interest in Legal Entity (see section 3.6).

Guarantor also enters into an arrangement with Insurer that requires Insurer to pay Guarantor for declines in the value of Legal Entity's assets. Guarantor and Insurer are not related parties.



Evaluation

Insurer has an implicit variable interest in Legal Entity. Although it does not directly guarantee Legal Entity's assets, the insurance contract is structured to transfer Legal Entity's variability from Guarantor to Insurer.

Question 3.5.20
How does an enterprise analyze whether a contract with an unrelated variable interest holder represents an implicit interest in a legal entity?

Interpretive response: The SEC staff addressed in a speech (see below) how an enterprise should analyze whether it has an implicit variable interest in a legal entity through a contractual arrangement with an unrelated party. [2005 AICPA Conf]

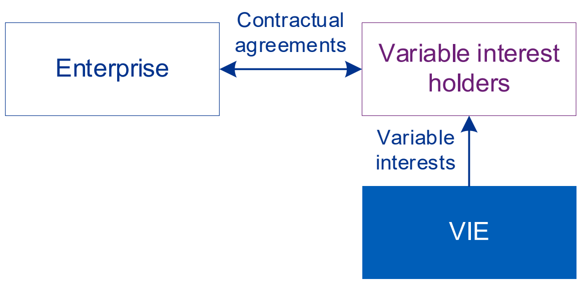
The speech emphasizes that when evaluating whether an implicit variable interest exists, an enterprise should exercise professional judgement based on the individual facts and circumstances. However, in doing so, it should consider the following circumstances:

— the timing of when the contract was entered into – i.e. at formation or concurrently with the issuance of the variable interest (see Question 3.5.30);

— the substance of the arrangement and why the contract was entered into with the variable interest holders instead of the legal entity (see Question 3.5.10); and

— whether any specified assets of the legal entity were referenced or noted in the contract and the nature of the assets (see Questions 3.5.40 and 3.5.50).

The following diagram illustrates the SEC staff's scenario.



Excerpt from SEC staff speech

At this conference last year, Jane Poulin briefly mentioned the need to consider "activities around the entity when applying [the VIE requirements of ASC Subtopic 810-10] and that certain types of activities could impact both the determination of whether an entity is a variable interest entity as well as identification of the primary beneficiary.[1]

The FASB staff addressed some of these issues earlier this year when they issued a staff position on implicit variable interests.[2] This FSP provides guidance for determining when activities around the entity would cause a reporting enterprise to have a variable interest. The FSP describes an implicit variable interest as an interest that absorbs or receives the variability of an entity indirectly rather than through contractual interests in the entity.[3] The guidance does not however provide a "bright-line for determining when an implicit variable interest exists. Instead, the FSP indicates that such determinations are a matter of judgment and will depend on the relevant facts and circumstances.[4]

At the end of the FSP, the FASB staff provides one comprehensive example of the how the FSP should be applied. In that example a company leases an asset from an entity that is entirely owned by a related party. Under the FSP, the lessee company would hold an implicit interest in the lessor company if it effectively guaranteed the related party's investment.

The guidance on implicit variable interests is important for a number of reasons. In particular, it helps meet the objective in [the VIE requirements of ASC Subtopic 810-10] that variable interest entities should be consolidated by a company that has a majority of the risks and rewards.[5] It also prevents registrants from circumventing the [VIE requirements of ASC Subtopic 810-10] by absorbing variability indirectly such as through an arrangement with another interest holder rather than directly from the entity.

With these thoughts in mind, I would like to highlight a few things about implicit variable interests. First, while much of the discussion in the FSP focuses on the example of a noncontractual interest in a leasing transaction between related parties, it is important to note that implicit interests can also result from contractual arrangements with unrelated variable interest holders. For instance, we recently evaluated a registrant's conclusion that it was not the primary beneficiary of a variable interest entity because it did not have any interest in the entity whatsoever. However, following several inquiries from the staff it became clear that the registrant had entered into contractual agreements with several of the variable interest holders that effectively protected those holders from absorbing a significant amount of the entity's variability. In this circumstance, we concluded that the contractual agreements with the variable interest holders were implicit interests in the variable interest entity. The registrant was, in fact, absorbing a majority of the expected losses through those implicit interests and was therefore the primary beneficiary despite having no direct contractual interest in the variable interest entity.

Consistent with the FASB staff's guidance, we believe that identification of implicit variable interests is a matter of judgment that depends on individual facts and circumstances. Again, there are no "bright-line" tests that can be applied to easily identify these arrangements. However, with this in mind, registrants should consider the following questions in evaluating whether or not a contractual arrangement with a variable interest holder is an interest in the entity:

- Was the arrangement entered into in contemplation of the entity's formation?
- Was the arrangement entered into contemporaneously with the issuance of a variable interest?
- Why was the arrangement entered into with a variable interest holder instead of with the entity?
- And lastly, did the arrangement reference specified assets of the variable interest entity?

While answers to these questions might not provide definitive conclusions for every circumstance, we believe that they will provide a good starting point for evaluating whether an implicit variable interest exists.

Mark Northan, Remarks before the 2005 AICPA National Conference on Current SEC and PCAOB Developments

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1 See remarks by Jane Poulin at the 2004 AICPA National Conference on SEC and PCAOB Developments.
2 FSP No. FIN 46(R)-5, Implicit Variable Interests under FASB Interpretation No. 46(R) [now included in ASC Subtopic 810-10].
3 Refer to paragraph 4 of FSP No. FIN 46(R)-5 [ASC paragraph 810-10-25-52].
4 Refer to paragraph 4 of FSP No. FIN 46(R)-5 [ASC paragraph 810-10-25-52].
5 Refer to paragraph E7 of FIN 46(R) [ASC paragraph 810-10-05-10] which states that "risks, benefits, or both are the determinants of consolidation in this Interpretation [the Variable Interest Entities Subsections]."

Question 3.5.30

Is a contract entered into at formation of a legal entity always an implicit interest in the legal entity?

Interpretive response: No. Not all contracts are implicit variable interests even if they are:

— executed with a variable interest holder in a legal entity; and
— entered into contemporaneously with, or in contemplation of, the formation of the legal entity.

However, we believe such contracts are part of the legal entity's design and should be considered when applying the by-design approach to identifying variable interests.

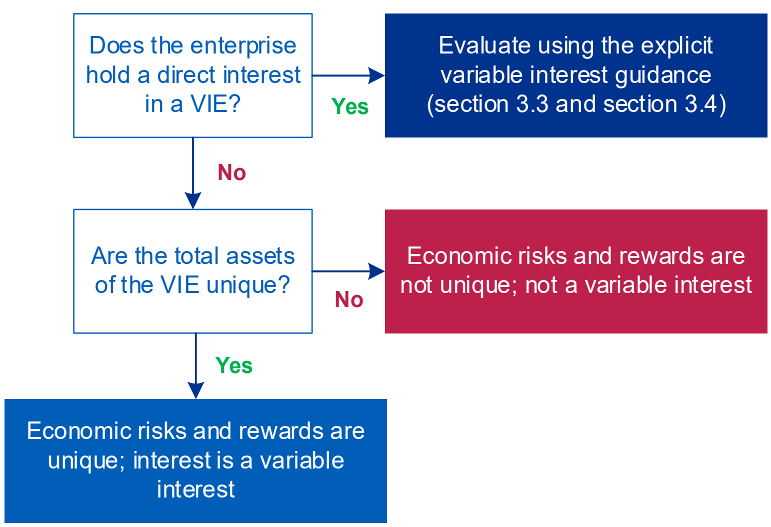
A contract in which a variable interest holder transfers some or all of its share of a legal entity's variability to an enterprise with no direct involvement with the legal entity is an implicit variable interest in the legal entity if the entity was designed to create and distribute that variability to its interest holders.

Question 3.5.40

Does the nature of the legal entity's assets affect whether an implicit variable interest exists?

Interpretive response: Yes. An enterprise that enters into a contract with a legal entity's variable interest holder has an implicit variable interest in the legal entity only if it absorbs the **unique** variability that the legal entity was designed to create and distribute to its interest holders.

The following diagram illustrates the decision sequence.



The economic risks and rewards of a legal entity's assets that are not present in the external marketplace are unique to the legal entity. Therefore, a contract that participates in some or all of those economic risks and/or rewards is a variable interest in the legal entity. This is the case even if the legal entity is not a counterparty to the contract that conveys the participation in that variability.

If the contract absorbs some of the legal entity's variability from its total assets that are not unique to the legal entity (or is an interest in only specified assets, see section 3.6), the contract generally is not an implicit interest in the legal entity. This is because exposure to that variability is readily accessible elsewhere in the marketplace. See Question 3.5.50 for guidance on how to determine if a legal entity's total assets are unique.

We do not believe the nature of the assets affects whether an enterprise that has a contract with the legal entity has a variable interest – i.e. whether the assets of the legal entity are unique is irrelevant when evaluating explicit interests.

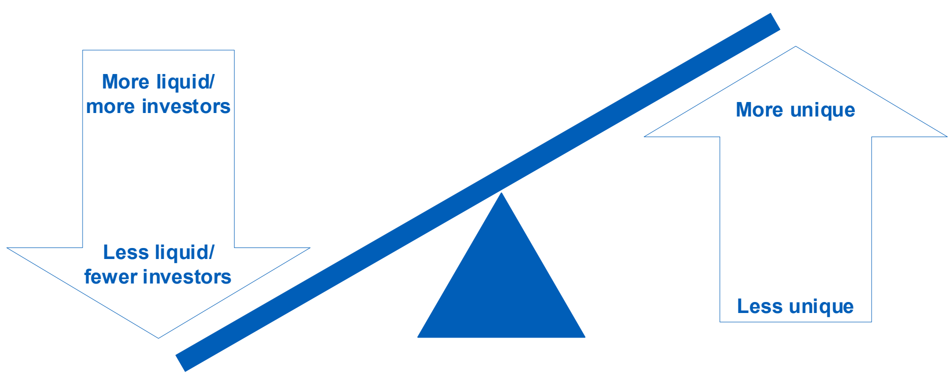
Question 3.5.50

What factors are considered when evaluating whether a legal entity's assets are unique?

Interpretive response: When determining whether the total assets of a legal entity are unique, an enterprise may consider the following factors.

Number of investors and market liquidity

Assets with few investors that trade in illiquid markets are less likely to be unique.

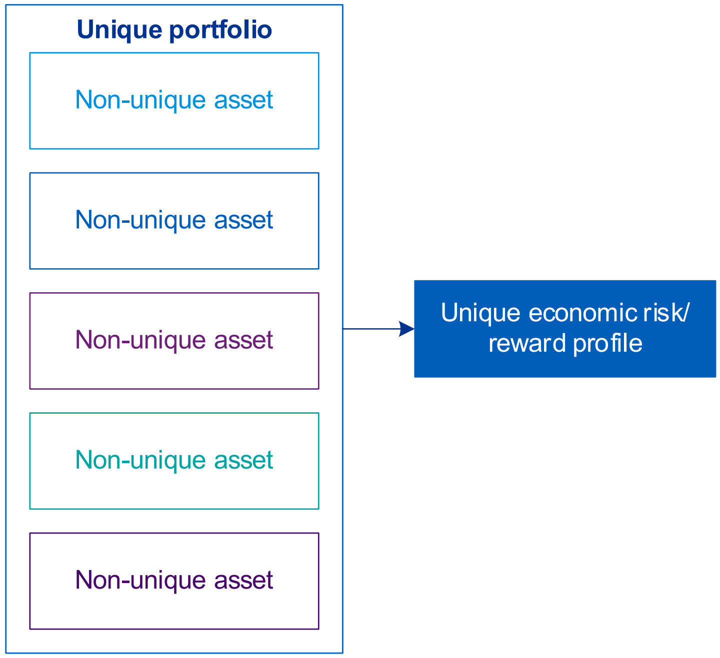


Assets available in liquid markets are generally not unique – e.g. treasuries, exchange-traded equity securities, public debt, rated debt, agency mortgage-backed securities.

Assets not available in a liquid market may be unique – e.g. specifically identified trade or loan receivables, physical assets, certain over-the-counter or thinly-traded equity instruments, lease receivables.

Risk and reward profile

Individual assets that are not themselves unique may be accumulated in such a way that the legal entity's total economic risk and/or reward profile is unique.



For example, a legal entity may hold only securities that are actively traded in a liquid market – e.g. a collateralized debt obligation entity (CDO) that holds only highly liquid debt securities. However, those securities may have been accumulated, and are managed, in a way that makes the risk and/or reward profile of the CDO itself unique. Therefore, an enterprise with an indirect interest in greater than 50% of the debt securities (see section 3.6 for guidance on interests in specified assets) may not have an implicit interest in the CDO, but an enterprise with an indirect interest in securities issued by the CDO may.

The reverse may also be true. We believe the individual commercial loans held by a collateralized loan obligation entity (CLO) are often unique assets, but the rated securities issued by the CLO typically are not. Therefore, an enterprise with an indirect interest in greater than 50% of the commercial loans (see section 3.6 for guidance on interests in specified assets) may have an implicit interest in the CLO, but an enterprise with an indirect interest in securities issued by the CLO may not.

Determining whether a legal entity's assets are unique requires judgment and should be based on all relevant facts and circumstances.

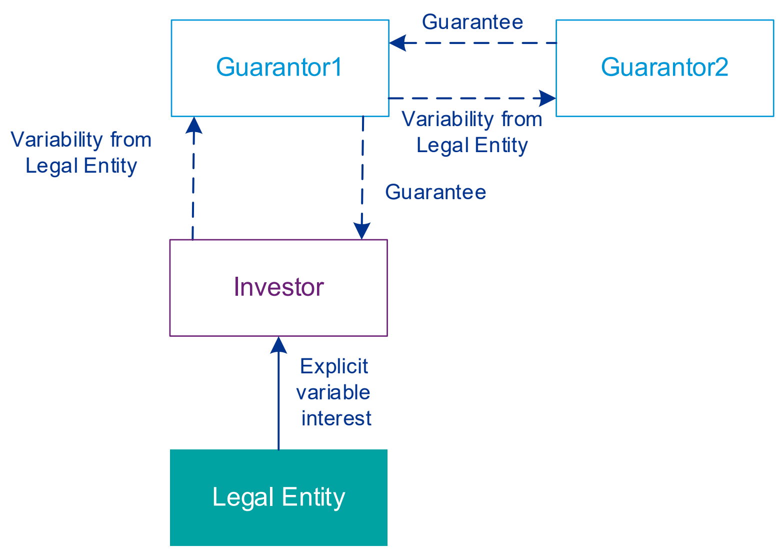
Question 3.5.60

Can a contractual arrangement with an implicit variable interest holder in a legal entity be an implicit variable interest in the legal entity?

Interpretive response: Yes. In certain circumstances implicit variable interests may absorb a portion of the variability of other implicit variable interests.

For example, this could occur if an enterprise (Guarantor1) executes the following contracts whereby it:

— guarantees Legal Entity's return to an explicit variable interest holder; and
— offsets that risk to second enterprise (Guarantor2).



In this situation, both Guarantor1 and Guarantor2 may have implicit variable interests in Legal Entity. Guarantor2's implicit variable interest reduces the variability absorbed by Guarantor1's implicit variable interest but may not entirely offset it (see Question 3.5.110).

Noncontractual variable interests

Question 3.5.70

Can a noncontractual arrangement outside a legal entity create an implicit variable interest?

Interpretive response: Yes. An enterprise may have an implicit variable interest in legal entity through a noncontractual arrangement with a variable interest holder.

Noncontractual implicit variable interests arise more often in transactions that involve related parties. The existence of related party relationships can significantly affect the analysis of whether a legal entity is a VIE (see chapter 4) and who consolidates the VIE (see chapter 6). As a result, an enterprise should evaluate whether it has an implicit variable interest in a legal entity in which a related party has an explicit interest. This evaluation should be done even if the enterprise believes its possible implicit variable interest in a legal entity is quantitatively minor. [810-10-25-51 – 25-54]

Question 3.5.80

What are some factors to consider when determining whether a noncontractual implicit variable interests exist?

Interpretive response: The follow table includes some of the factors to consider in determining whether a noncontractual implicit variable interest exists.

Factors to consider	Examples
Nature of the relationship with other variable interest holders, including whether another variable interest holder has the ability to control the reporting enterprise	The CEO of an enterprise also has a controlling financial interest in a legal entity that is the only supplier of a product or service to the enterprise. This may indicate that the enterprise has implicitly guaranteed that the legal entity will not incur losses from the supply arrangement.
Nature of the economics between the enterprise and other variable interest holders	Parent has a controlling financial interest in an enterprise but owns less than 100%. Parent wholly owns another legal entity. This may indicate that there is an economic incentive for Parent to cause the enterprise to provide financial support to the legal entity. See Question 3.5.90 for additional considerations relevant to related party relationships.
Restrictions or regulations under which the enterprise operates	Legal entity is subject to possible punitive regulatory action. Direct or indirect financial support from the enterprise is necessary to prevent or cure such action. Conversely, an enterprise may be subject to laws and regulations that make it a conflict of interest or illegal to provide support to a legal entity that it is not contractually obligated to provide. Governance provisions or other controls that apply to the enterprise may also preclude it from providing support to a legal entity. For example, a lessee may be unable to provide support to its related party lessor that it is not contractually obligated to provide if the lessee has an independent board or committee of the board that: — is required to review related party leasing transactions; and — can approve them only if they are determined to be on market terms; see Question 3.5.90 for additional guidance on related party leases.
Whether other parties that are involved with the enterprise or legal entity believe that an implicit variable interest exists	The interest offered on debt issued by an SPE may be lower if there is a reasonable expectation in the market that a sponsoring enterprise will provide financial support to the legal entity in the event of default.

Factors to consider	Examples
Whether the enterprise has provided support that it was not obligated to provide to the legal entity in the past	When an enterprise has previously provided support to a legal entity that it was not obligated to provide, this may indicate that it would do so again – either for that legal entity or for similar legal entities with which it is involved. In some cases, an enterprise's history of providing support that it was not obligated to provide may establish a reasonable expectation in the market that the enterprise would provide support in the future.

Question 3.5.90

Does an enterprise evaluate a plain vanilla operating lease for an implicit variable interest if it involves a related party?

Background: An operating lease is not a variable interest in the lessor if it is a plain vanilla operating lease. A 'plain vanilla' operating lease does not contain off-market purchase or renewal options or residual value guarantees (see Question 3.4.130). [810-10-55-39]

Interpretive response: Yes. One of the principal reasons for the guidance on implicit variable interests was the concern that a lessee could avoid consolidation of a related party lessor by protecting the lessor from losses implicitly instead of explicitly.

Implicit protection from losses can take many forms. For example, it could be implied reimbursement of losses or pressure (or control) to renew the lease at an above-market rate of rent.

Related party leases that are more likely to result in the lessee having an implicit variable interest in the lessor include when: [810-10-25-53 – 25-54]

— the lessee and lessor are under common control (see Question 3.8.230);

— the lessor is owned by a party with the ability to exercise significant influence over the lessee – e.g. through ownership of a significant share of the lessee's voting stock; or

— the lessor is owned by a party with a significant role in the lessee's operations – e.g. a member of the lessee's senior management, such as the CEO or a member of the lessee's board of directors.

However, private companies have an option not to apply the VIE guidance to certain related party arrangements (see section 2.6).

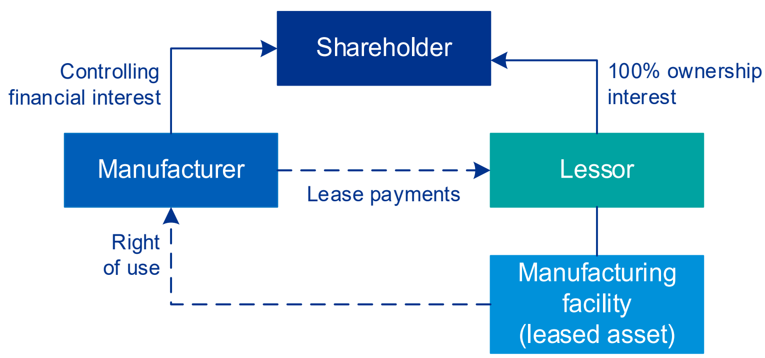
Example 3.5.40
Implicit variable interest in a leasing arrangement

This example is based on an example that appeared in Topic 810 before the private company alternative for common control leasing arrangements was effective (see section 2.6). Although the example was removed when the alternative became effective, we believe it remains relevant for enterprises that do not qualify for, or do not elect, the alternative.

Background

Lessor leases to Manufacturer a facility under an operating lease. The lease was executed with market terms and contains no explicit residual value guarantees or purchase options; it is not considered an explicit variable interest in Lessor. The operating lease is the only contractual relationship between Manufacturer and Lessor.

Lessor owns no assets other than the manufacturing facility being leased to Manufacturer. Shareholder has a controlling financial interest in Manufacturer and wholly owns Lessor. Shareholder guarantees Lessor's debt.



Evaluation

The lease is a plain vanilla operating lease. However, Manufacturer should consider whether the following conditions exist that suggest it has an implicit variable interest in Lessor.

- Manufacturer effectively guarantees Shareholder's investment in Lessor.
- Manufacturer is expected to make funds available to Lessor to prevent Shareholder from paying out on its guarantee of Lessor's debt. For example:
  - there is an economic incentive for Manufacturer to act as a guarantor or to make funds available;
  - Manufacturer has made funds available under similar circumstances in the past;
  - Manufacturer may act as a guarantor or make funds available without that action being considered a conflict of interest or illegal.

The existence of an implicit variable interest does not affect lease classification under Topic 842.

Question 3.5.100

Can a noncontractual implicit variable interest arise from an arrangement with an unrelated party?

Interpretive response: Yes. Noncontractual implicit variable interests are not limited to arrangements that involve related parties. An enterprise should consider all relevant facts and circumstances when evaluating whether a reporting enterprise has a noncontractual implicit variable interest in an entity (see Question 3.5.80). [810-10-25-51]

Question 3.5.110

How does the existence of an implicit variable interest affect the variability absorbed by the explicit variable interests?

Interpretive response: A legal entity's variable interests collectively absorb all of the economic risks and rewards that the entity is designed to create and pass along to its interest holders. When a legal entity has implicit and explicit variable interests, a portion of the variability directly absorbed by the explicit variable interests shifts to the implicit variable interests. As a result, the variability absorbed by the implicit variable interests reduces the variability absorbed by the explicit variable interests.

However, the amount of the variability absorbed by an implicit variable interest holder may not entirely offset the variability that the explicit holder believes it is transferring. This occurs because the explicit variable interest holder is exposed to the implicit variable interest holder's credit risk. The explicit variable interest holder retains some variability in the legal entity due to the risk of default by the implicit variable interest holder.

It also occurs if the implicit variable interest is noncontractual because there is no legal obligation requiring the implicit variable interest holder to absorb the legal entity's variability. The explicit variable interest holder retains some variability in the legal entity due to the risk of nonperformance by the implicit variable interest holder.

As a result of these sources of retained exposure, the variability expected to be absorbed by implicit variable interests may exceed the actual reduction in variability that the explicit variable interest holders expected.

Question 3.5.120

Are a legal entity's variable interest holders re-evaluated when an enterprise provides support that it is not obligated to provide?

Interpretive response: Generally, yes. When an enterprise provides a legal entity support that it is not obligated to provide, this generally creates new variable interests.

This situation occurs most often in investment management structures whereby an enterprise serves as the sponsor to many different investment entities (see Question 3.5.130).

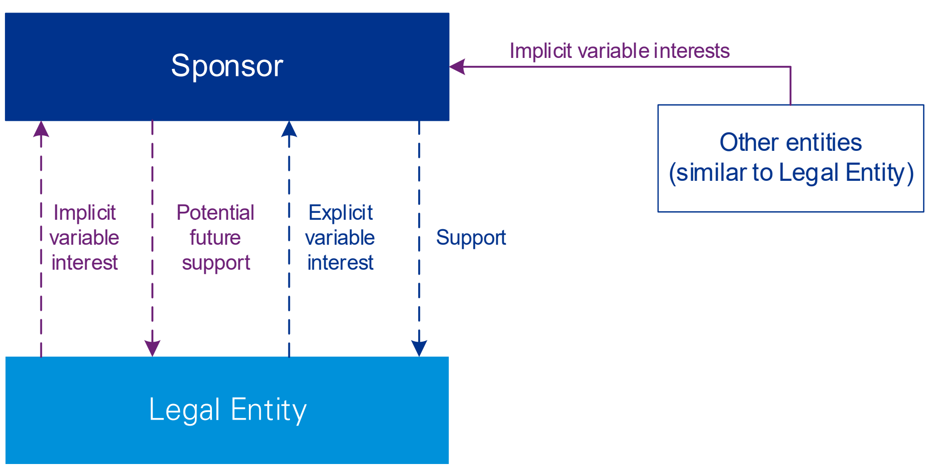
When a sponsor provides support to an investment entity that the sponsor is not obligated to provide, we believe the sponsor obtains:

— a new explicit variable interest in that investment entity in the form of the actual support provided, which may be ongoing (e.g. if the support is a standby letter of credit); and

— a new implicit variable interest to provide future support to that investment entity.

Providing support to one investment entity may also create a new implicit interest for the sponsor to provide support to other investment entities. We believe the sponsor has an implicit interest in other sponsored investment entities if investors have a reasonable expectation that the sponsor would provide similar support. Investors may have that expectation if the investment entities in which they invest are similar to the investment entity that the sponsor has supported in the past (through one-time support or ongoing support).

See Question 3.5.80 for additional discussion of the factors to consider when determining whether a noncontractual implicit variable interest exists.



There may be some scenarios in which an enterprise provides a legal entity support that it is not obligated to provide but does not have a variable interest in the entity itself. We believe a variable interest in the legal entity is not created if:

- the support is limited to absorbing the variability of specified assets of the legal entity that do not comprise more than 50% of the entity's total assets (see section 3.6); and
- the enterprise is willing and able to assert that it would not provide support for losses arising from other assets of the legal entity if such losses occurred.

The nature of the variability absorbed by the implicit variable interest depends on the nature of the support actually provided and the risks that explicit variable interest holders in the legal entity would have absorbed in the absence of the support.

Question 3.5.130

What are common sources of support a sponsor may provide to an investment entity?

Background: During past economic downturns, investment entities have experienced losses for a variety of reasons – e.g. as a result of turmoil in the credit markets. Losses have often led to rating agency downgrades of securities issued by those investment entities and declines in the securities' fair values.

Sponsors of investment entities that suffer the effects of economic downturns may provide support to the entities they sponsor even if they are not contractually required to do so. Sponsors may choose to support these entities to limit the downward fluctuations in fair value of the related investment securities and reduce the economic losses of the investors.

Investment entities include, but are not limited to, structured investment vehicles (SIVs), mutual funds, collateralized debt obligation entities; collateralized loan obligation (CLO) entities, hedge funds, separate accounts, bank common and collective trust funds, and commercial paper (CP) conduits.

Interpretive response: Common types of financial support provided by sponsors/advisors include the following (not exhaustive):

- capital contributions;
- agreements to purchase assets at an amount above fair value – e.g. at par value when the fair value is less than par;
- agreements to purchase interests issued by the investment vehicle for the sponsor's own account to create liquidity;
- guarantees of principal and interest;
- guarantees of a specific financial instrument held by the investment vehicle, including partial guarantees;
- liquidity support agreement;
- standby letters of credit; and
- assertions that support may be provided.

Question 3.5.140

Does an investment manager waiving its fee create a variable interest in an investment entity?

Background: Investment managers of investment entities (funds) generally earn a fee that is based on a percentage of the fair value of the assets under management. During periods of economic downturn, some managers choose to waive all or a portion of their management fees for a limited period of time.

Interpretive response: No. We believe a limited management fee waiver by an investment manager does not cause the investment manager to have an implicit variable interest in a fund.

The purpose of a management fee is to compensate the manager for its ongoing duties to manage the fund's investments. A limited fee waiver does not absorb the risks that a fund was designed to create and distribute to its interest holders. Instead, we believe waiving the management fee for a limited period of time can be viewed as a reduction in compensation to the manager for substandard performance – i.e. failing to fulfill its duty to effectively manage the fund's investments.

However, when an investment manager waives its fees for more than a limited period, additional analysis is necessary. Extended waivers may suggest that the overall fee arrangement is not commensurate and customary for the services performed (see section 3.8). In that case, the fee is a variable interest.

Other types of support provided by an investment manager may themselves represent an implicit variable interest (see Question 3.5.120).

3.6 Specified assets

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

>> Variable Interest and Interests in Specific Assets of a VIE

25-55 A variable interest in specified assets of a VIE (such as a guarantee or subordinated residual interest) shall be deemed to be a variable interest in the VIE only if the fair value of the specified assets is more than half of the total fair value of the VIE's assets or if the holder has another variable interest in the VIE as a whole (except interests that are insignificant or have little or no variability). This exception is necessary to prevent a reporting entity that would otherwise be the primary beneficiary of a VIE from circumventing the requirement for consolidation simply by arranging for other parties with interests in certain assets to hold small or inconsequential interests in the VIE as a whole. The expected losses and expected residual returns applicable to variable interests in specified assets of a VIE shall be deemed to be expected losses and expected residual returns of the VIE only if that variable interest is deemed to be a variable interest in the VIE.

25-56 Expected losses related to variable interests in specified assets are not considered part of the expected losses of the legal entity for purposes of determining the adequacy of the equity at risk in the legal entity or for identifying the primary beneficiary unless the specified assets constitute a majority of the assets of the legal entity. For example, expected losses absorbed by a guarantor of the residual value of underlying asset are not considered expected losses of a VIE if the fair value of the underlying asset is not a majority of the fair value of the VIE's total assets.

An interest in specific assets of a legal entity is not a variable interest in the legal entity if:

— the fair value of the specific assets is 50% or less of the fair value of the legal entity; and
— the holder has only an insignificant other variable interest in the legal entity.

Such an interest is referred to as an 'interest in specified assets'. An interest in specified assets is generally excluded when applying the guidance on determining whether a legal entity is a VIE and if so, what party (if any) should consolidate it. [810-10-25-55 – 25-56]

However, there is a particular subset of interests in specific assets of a VIE that require separate analysis: silo VIEs. A silo VIE's assets, liabilities and other interests are essentially segregated economically from the rest of VIE.

— This section generally addresses matters involving interests in specific assets that are not silo VIEs.
— Section 3.7 addresses matters involving silo VIEs.

Interaction between the guidance for specified assets and the guidance for silo VIEs is complex, and careful consideration of the facts is necessary when evaluating. [810-10-25-57]

Question 3.6.10

How is the guidance on interests in specified assets applied?

Interpretive response: An interest in specific assets of a legal entity is not a variable interest in the entity itself only if both of following criteria are met: [810-10-25-55]

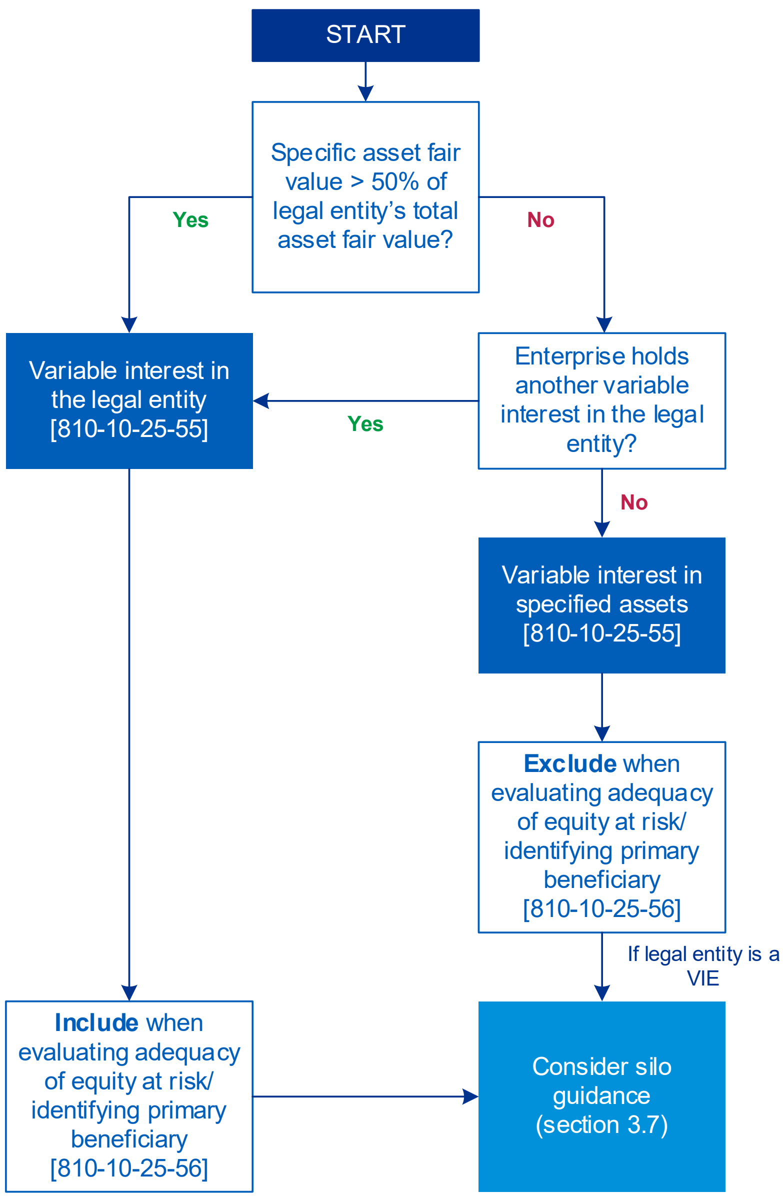
— the fair value of the specific assets represents 50% or less of the fair value of the legal entity's total assets (after removing any silo VIEs, see Question 3.6.30); and

— the holder of the interests in the specific assets has only an insignificant other variable interest in the legal entity, if any.

If the criteria are met, the interest is referred to as an 'interest in specified assets'. The variability absorbed by interests in specified assets is excluded from the legal entity's total variability when applying the VIE guidance (see Question 3.6.40).

Conversely, an interest in specific assets represents a variable interest in the legal entity itself if the fair value of the specific assets represents more than 50% of the fair value of the legal entity's total assets. Such an interest would generally shield the equity-at-risk group from absorbing the legal entity's expected losses. If the equity-at-risk group is shielded from absorbing the legal entity's expected losses, the third VIE characteristic is triggered and the legal entity is a VIE (see Question 4.5.10).

The following decision tree illustrates how to determine whether an interest that conveys to a holder the right to absorb variability from only certain assets of an entity ('specific assets') meets the definition of specified assets. [810-10-25-56]



Although an interest in specified assets is excluded when evaluating the legal entity that holds the assets, further analysis is required if it is determined that the legal entity is a VIE (see Question 3.6.30).

Question 3.6.20

Can an undivided interest be an interest in specified assets or a potential silo?

Interpretive response: No. If an enterprise owns an undivided interest in each of a legal entity's assets and is proportionately liable for its share of each of the liabilities, it generally accounts for its investment in the legal entity under the equity method of accounting. [323-10-15-3 – 15-11, 323-30-15-1 – 15-4, 970-323-25-12]

However, there is an exception if the investor enterprise and the legal entity operate in the construction or extractive industries. In that situation, the enterprise applies the recognition and measurement principles in Topic 323 (equity method), but may present its proportionate share of the legal entity's individual assets, liabilities and operations. [810-10-45-14, 910-810-45-1, 930-810-45-1, 932-810-45-1]

A similar exception exists for undivided interests in real property that is not subject to joint control if certain conditions are met. [970-810-45-1]

See section 2.3 of KPMG Handbook, Equity method of accounting, for additional guidance on how to account for undivided interests.

Question 3.6.30

How does the guidance on interests in specified assets and silo VIEs interact?

Interpretive response: The interaction of the guidance on interests in specified assets and silo VIEs is complex and often requires judgment. Not all interests in specified assets of a legal entity are silo VIEs. Similarly, silo VIEs are not always interests in specified assets. Either one can exist without the other, and both can exist within one entity.

An interest in specified assets of a legal entity may be a potential silo if: [810-10-25-57 – 25-58]

— the interest is in an asset whose fair value comprises ≤ **50%** of the fair value of the legal entity's total assets – i.e. meets the interest in specified assets criterion in Question 3.6.10; and

— it is economically segregated (see section 3.7).

An interest in *specific* assets of a legal entity may be a potential silo if:

— the interest is in an asset whose fair value comprises **> 50%** of the fair value of the legal entity's total assets – i.e. does not meet the interest in specified assets criterion in Question 3.6.10; and

— it is economically segregated (see Question 3.7.40).

Analyzing interests in specified assets and potential silos is more complex when both may be present in a legal entity. The following steps explain how an enterprise applies the guidance on interests in specified assets and silo VIEs.

Step 1	**Identify any potential silos and interests in specified assets**	**Potential silos** See section 3.7 **Interests in specified assets** Interests in assets whose fair values comprise ≤ 50% of the fair value of the legal entity's total assets (see Question 3.6.10) **Next step** **Go to Step 2**
Step 2	**If there are no potential silos:** — **Go straight to Step 3a** **If there are potential silos:** — Determine if the potential silos are silo VIEs – i.e. if the residual entity is a VIE — Separate silo VIEs from the legal entity, leaving a host VIE.	**Silo VIEs:** A potential silo is a silo VIE if the residual entity is a VIE. **Evaluating the residual entity:** The 'residual entity' is defined as the actual legal entity excluding interests in specified assets. If the fair value of the potential silo's assets comprises: — > 50% of the fair value of the legal entity's total assets → the potential silo stays in the residual entity when evaluating whether the residual entity is a VIE. This typically results in the residual entity being a VIE (see Question 3.6.10) — ≤ 50% of the fair value of the legal entity's total assets → the potential silo (along with other interests in specified assets of the legal entity that are not potential silos) is removed from the legal entity when evaluating whether the residual entity is a VIE. **Next step:** **If there are no other interests in specific assets of the host VIE:** Determine which party, if any, is the primary beneficiary of the host VIE and each of the silo VIEs under the VIE consolidation model. **STOP** **If there are interests in specific assets of the host VIE:** **Go to Step 3** **If the residual entity is not a VIE:** The potential silo is not a silo VIE. The legal entity is a VOE and is analyzed for consolidation under the VOE consolidation model. **STOP**

Step 3	**Identify variable interests in the host VIE** **Determine which party is the primary beneficiary of the:** — host VIE (if any); and — each silo VIE identified in Step 2	**Variable interests in the host VIE include:** An interest in specific assets whose fair value comprises > 50% of the fair value of the host VIE's total assets **Variable interests in the host VIE exclude:** An interest in specific assets whose fair value comprises ≤ 50% of the fair value of the entity's total assets **For the host VIE and each silo VOE:** Determine which party, if any, is the primary beneficiary under the VIE consolidation model. The primary beneficiary must have a variable interest in the VIE. An enterprise with a variable interest in specified assets of the host VIE (versus an interest in the entire host VIE) cannot be the host VIE's primary beneficiary. **STOP**
Step 3a	**Analyze interests in specific assets.** **Determine if the residual entity is a VIE**	**Analyzing interests in specific assets:** See Question 3.6.40. An interest in assets whose fair value comprises: — > 50% of the fair value of the legal entity's total assets → interest in the legal entity. — ≤ 50% of the fair value of the legal entity's total assets → interest in specified assets of the legal entity **Evaluating the residual entity:** The 'residual entity' is defined as the actual legal entity excluding interests in specified assets. If the interest is in assets whose fair value comprises: — > 50% of the fair value of the legal entity's total assets→ the interest stays in the residual entity when evaluating whether the residual entity is a VIE. This typically results in the residual entity being a VIE (see Question 3.6.10) — ≤ 50% of the fair value of the legal entity's total assets → the interest is removed from the legal entity when evaluating whether the residual entity is a VIE. **If the residual entity is a VIE:** Determine which party, if any, is the primary beneficiary under the VIE consolidation model. The primary beneficiary must have a variable interest in the VIE. An enterprise with a variable interest in specified assets of the

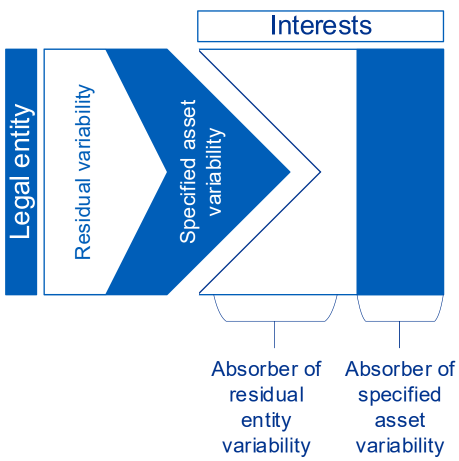
		legal entity (versus an interest in the entire legal entity) cannot be the VIE's primary beneficiary. **STOP** **If the residual entity is a VOE**: Determine which party, if any, has a controlling financial interest under the VOE consolidation model. **STOP**

Question 3.6.40

What effect do interests in specified assets have on the variability absorbed by a legal entity's variable interests?

Interpretive response: An interest in specified assets of a legal entity and the related variability from the assets are excluded from the legal entity when applying the VIE guidance. As a result, identifying an interest in specified assets creates a residual entity – i.e. the entity that remains after removing the variability from the specified assets and the related interests in those assets. As a reminder, an 'interest in specified assets' is an interest in assets whose fair values comprise 50% or less of the fair value of the legal entity's total assets (see Question 3.6.10). [810-10-25-56]

In the following diagram, the areas shaded in blue are excluded when determining whether the entity is a VIE and what party, if any, consolidates it.



Excluding the variability from specified assets often results in a lower likelihood that the residual entity is a VIE. For example, a residual value guarantee in a lease may represent an interest in specified assets. If it does, the expected losses from the leased asset subject to the guarantee are excluded from the expected losses of the residual lessor entity. This can result in the residual lessor entity needing less equity at risk to demonstrate that it can finance its operations without additional subordinated financial support (see section 4.3).

However, there are situations in which excluding the variability from interests in specified assets results in the residual entity being a VIE even if the legal entity in its totality otherwise would be a VOE. This is more common when the entire legal entity comprises individual interests in specified assets because the residual entity would be left with no equity at risk (see Question 4.3.70).

If the residual entity is not a VIE	If the residual entity is a VIE
The entire legal entity (including the interest in specified assets) is evaluated for consolidation under the VOE consolidation model (see Question 3.7.10).	The entire VIE is evaluated under the VIE consolidation model. The holder of the interest in specified assets cannot be the VIE's primary beneficiary. This is because the interest in specified assets is not a variable interest in the VIE (see Question 3.6.10).

Analyzing interests in specific assets of a legal entity is more complex when silo VIEs are also present in the legal entity. This is because silo VIEs are separated from the legal entity, leaving a host VIE.

— Question 3.6.30 includes steps that explain how an enterprise analyzes a legal entity when there are interests in specified assets of the legal entity, potential silos in the legal entity, or both.

— Question 3.7.70 illustrates the effect that interests in silo VIEs have on the variability absorbed by an interest in specified assets.

Computing the variability to be absorbed can be complex. See chapter 10 provides guidance on computing expected losses and residual returns.

Question 3.6.50

Does an enterprise have a variable interest in a legal entity if together with its related parties it holds interests in specific assets that collectively put it over the 50% threshold?

Interpretive response: Yes. An enterprise and its related parties (see section 6.5.20) may have multiple interests in separate groups of specified assets in a legal entity with each interest comprising 50% or less of the total fair value of the entity's assets. However, if collectively the interests comprise more than 50% of the fair value of the legal entity's assets, we believe the enterprise and its related parties each have a variable interest in the entity.

For example, an enterprise provides credit support to one third of a legal entity's assets and its related party provides liquidity support to a second third of the same legal entity's assets. In this example, the specified assets in which the enterprise and its related party have an interest collectively represents greater than 50% of the fair value of the legal entity's assets. Therefore, we believe the enterprise and its related party each have a variable interest in the legal entity. The expected variability that is absorbed by those interests is included in the legal entity's expected losses when evaluating equity at risk (see section 4.3) and when identifying the primary beneficiary (see chapter 6). [810-10-25-56]

Question 3.6.60

Do unrelated parties have variable interests in a legal entity if their interests in specific assets collectively put them over the 50% threshold?

Interpretive response: No. If multiple unrelated parties hold interests in separate specified assets, an individual interest is a variable interest in the legal entity only if the fair value of the specified asset(s) represents greater than 50% of the entity's total assets (unless the holder has an other variable interest, see Question 3.6.10).

For example, a lessor entity with multiple leased assets has separate residual value guarantees provided by multiple unrelated guarantors. None of the guarantors individually provide guarantees on an asset (or assets) whose fair value comprises more than 50% of the lessor entity's fair value. Therefore, none of the guarantors have a variable interest in the lessor entity.

A similar situation often arises in securitization transactions. In those transactions, many unrelated financial institutions transfer financial assets into a legal entity and provide credit or liquidity support only to the individual assets that they transferred. If none of the transferors individually support assets whose fair value comprises more than 50% of the transferee entity's fair value, none have a variable in the transferee entity.

Question 3.6.70

Can an interest rate swap be an interest in specified assets?

Interpretive response: No. We believe an interest rate swap is a general obligation of a legal entity and not an interest in specified assets. The payments made to and from the legal entity and the counterparty are not generally dependent on cash flows generated by specified assets of the entity.

However, interest rate swaps often are a creator of variability; creator characteristics are discussed in section 3.3.40.

3.7 Silos

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

>> Variable Interest and Interest in Specific Assets of a VIE

25-57 A reporting entity with a variable interest in specified assets of a VIE shall treat a portion of the VIE as a separate VIE if the specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities or specified other interests. (The portions of a VIE referred to in this paragraph are sometimes called silos.) That requirement does not apply unless the legal entity has been determined to be a VIE. If one reporting entity is required to consolidate a discrete portion of a VIE, other variable interest holders shall not consider that portion to be part of the larger VIE.

25-58 A specified asset (or group of assets) of a VIE and a related liability secured only by the specified asset or group shall not be treated as a separate VIE (as discussed in the preceding paragraph) if other parties have rights or obligations related to the specified asset or to residual cash flows from the specified asset. A separate VIE is deemed to exist for accounting purposes only if essentially all of the assets, liabilities, and equity of the deemed VIE are separate from the overall VIE and specifically identifiable. In other words, essentially none of the returns of the assets of the deemed VIE can be used by the remaining VIE, and essentially none of the liabilities of the deemed VIE are payable from the assets of the remaining VIE.

As discussed in section 3.6, sometimes the contractual arrangements within a legal entity economically segregate a portion of the legal entity's assets, related liabilities and certain other interests from the rest of the legal entity's assets and related variable interests.

A segregated group of assets, liabilities and other interests is referred to as a potential silo. A potential silo exists only if essentially none of the assets of the potential silo can be used by the rest of the legal entity and essentially none of the liabilities of the potential silo can satisfied by the assets by the rest of the legal entity. [810-10-25-58]

A potential silo is accounted for separately as a silo VIE only if the residual entity is a VIE. The residual entity is the legal entity minus any interests in specified assets. An interest in specified assets is an interest in assets whose fair values comprise 50% or less of the fair value of the legal entity's total assets (see section 3.6). As a result, when considering the residual entity to determine whether it is a VIE, the potential silo is removed if it is an interest in specified assets.

A potential silo that is not an interest in specified assets (because the fair value of its assets comprises greater than 50% of the legal entity's total assets), is not removed from the legal entity when determining whether the residual entity is a VIE. This situation typically results in the residual entity being a VIE because the equity-at-risk group is shielded from absorbing expected losses (see Question 3.6.10) [810-10-25-55 – 25-57]

If a silo VIE is identified in a VIE, the VIE consolidation guidance is applied separately to:

— the silo VIE; and
— to the host VIE – i.e. the legal entity minus the silo VIE.

Question 3.7.10

Can a silo VIE exist within a legal entity that is not a VIE?

Interpretive response: No. Silo VIEs exist only if the two following statements are true. [810-10-25-57]

1	Essentially all of the assets, liabilities and equity of the potential silo are separate from the overall entity and specifically identifiable.
2	The residual entity (the legal entity minus any interests in specified assets) is a VIE.

Divisions, departments, branches and pools of assets subject to liabilities that provide the creditor recourse only to specified assets are common and may represent interests in specified assets (see section 3.6). However, these cannot be silo VIEs if the residual entity is not a VIE. In that case, the entire legal entity is evaluated under the VOE consolidation model.

The residual entity is the legal entity excluding the effects of interests in specified assets (see section 3.6), if any. Recall that an interest in specified assets is an interest in assets whose fair values comprise 50% or less of the fair value of the legal entity's total assets.

When constituting the residual entity, an enterprise must exclude all interests in specified assets. An enterprise also excludes the potential silo being evaluated if the potential silo's assets meet the definition of specified assets – i.e. if the fair value of the potential silo's assets comprises 50% or less of the fair value of the legal entity's total assets and other interests in specified assets that are unrelated to the potential silo.

Conversely, if the potential silo's assets do not meet the definition of specified assets – i.e. the fair value of the potential silo's assets comprise more than 50% of the fair value of the legal entity's total assets – the residual entity includes those assets (and the related interest in those assets) when evaluating whether that residual entity is a VIE. The only interests that are excluded when constituting the residual entity are those interests in specified assets – i.e.

assets whose fair value comprise 50% or less of the fair value of the legal entity's total assets.

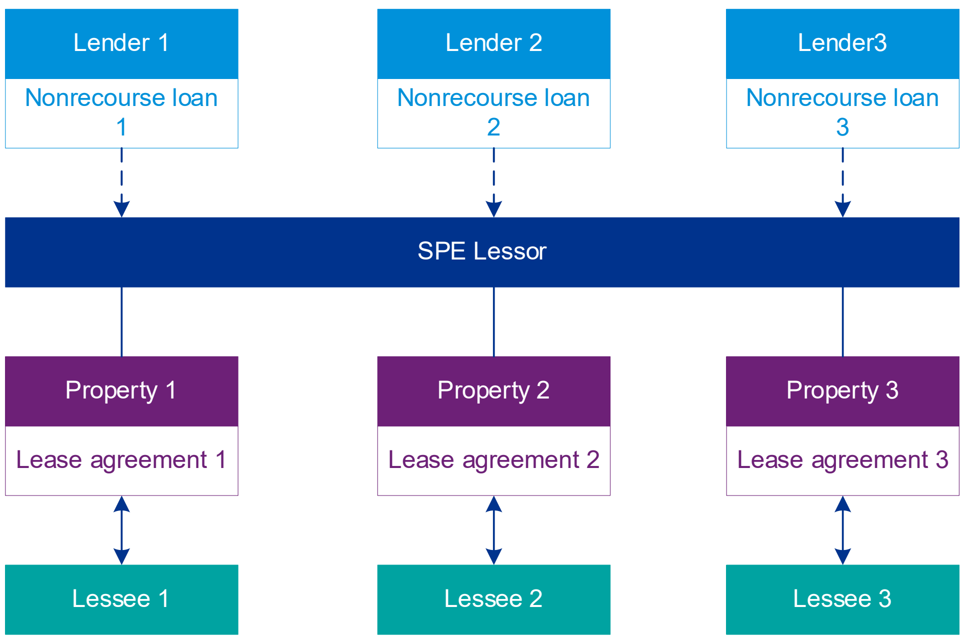
If the fair value of the potential silo's assets comprises more than 50% of the fair value of the legal entity's total assets, then the residual entity is typically a VIE because the equity-at-risk group is shielded from absorbing expected losses (see Question 3.6.10).

Question 3.6.30 includes steps that explain how an enterprise analyzes a legal entity when there are interests in specified assets of the legal entity, potential silos in the legal entity, or both.

Question 3.7.20

Can there be more than one silo VIE in a VIE?

Interpretive response: Yes. A common example of a VIE with multiple silo VIEs is an SPE lessor. These entities are typically structured as follows.

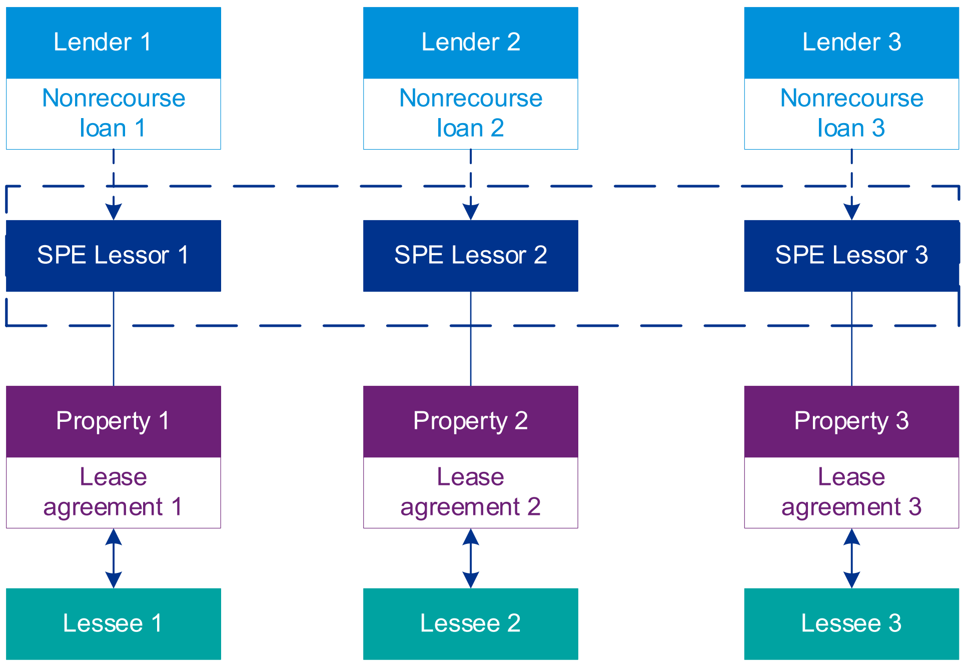


In this structure:

— there is a single SPE lessor and the residual entity is a VIE;
— each leased property is leased to a different lessee;
— other than the leased properties (and the related leases), SPE Lessor holds no other assets;
— the leased properties are each financed with separate nonrecourse borrowings that do not contain cross-collateral provisions;
— only a trivial amount of the variability of the leased properties are absorbed or received by the variable interest holders in the residual VIE;

— in the event of default, each borrowing is collateralized by a pledge of the respective leased property and an assignment of the respective lease payments under the lease.

The use of nonrecourse debt with no cross-collateral provisions effectively segregates the cash flows and assets associated with the multiple leases. The economics of the single SPE Lessor are no different than if the transactions had been structured as illustrated in the following diagram.



As a result, this arrangement results in the identification of three silo VIEs. Each silo VIE is evaluated for consolidation as if it were a separate VIE. [810-10-25-58]

Before the VIE consolidation guidance was issued, the EITF addressed the accounting for silos. Under that pre-VIE guidance, a lessee was required to consolidate an SPE lessor only when substantially all of the activities of the SPE involved assets that were leased to a single lessee, among other requirements. The EITF's guidance no longer applies to enterprises that are subject to the VIE guidance in Subtopic 810-10, but still applies to SPEs used by NFP entities that apply Subtopic 958-810. [958-810-25-8, 55-9]

Question 3.7.30

Can a specified asset and related liability be a potential silo if the legal entity's interest holders share the asset's returns?

Interpretive response: Generally, no. For a potential silo to exist, the specified assets must represent essentially the only source of payment for the specified liabilities or other interests. For the specified assets to represent essentially the only source of payment, generally no more than a trivial amount of the economics associated with those assets (i.e. expected losses and returns) may be absorbed or received by the variable interest holders in the residual VIE. [810-10-25-58]

For example, a potential silo with an asset is financed 100% with nonrecourse debt. The asset is owned by a VIE and the residual entity is a VIE. The equity holder in the VIE receives the residual returns associated with the excess of the fair value of the asset over the amount of debt repayments. The asset and related nonrecourse debt do not represent a potential silo because the equity holders in the VIE share in the asset's residual returns.

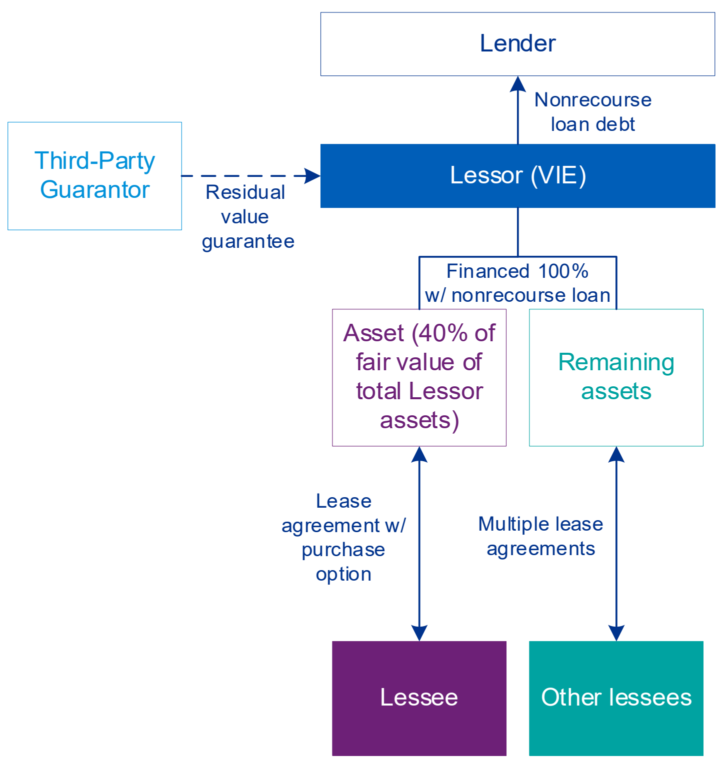
Example 3.7.10
Lessor VIE with residual value guarantee and purchase option

Background

Lessor leases an asset with a fair value that represents approximately 40% of the fair value of its total assets. The leased asset is financed 100% with nonrecourse debt. Residual entity (Lessor minus the potential silo, which is an interest in specified assets) is a VIE.

Third Party Guarantor provides a residual value guarantee. The guaranteed amount is equal to the expected future fair value of the leased property at the inception of the lease.

Lessee has a purchase option to acquire the leased property at the end of the lease term.



Scenario 1: Purchase option at fair value

Lessee has a purchase option to acquire the leased property at its future fair value at the end of the lease term.

Evaluation

The leased asset and related nonrecourse debt do not represent a silo VIE.

The equity participants in Lessor receive the residual returns associated with the excess of the fair value of the leased asset over the guaranteed residual value at the end of the lease term. Therefore, the equity investors are entitled to more than a trivial amount of the asset's returns. To be a silo VIE, essentially none of the returns of the assets of the potential silo can be used by the residual VIE.

Lessee has a variable interest in specified assets of the Lessor instead of an interest in the Lessor itself (see section 3.6).

Scenario 2: Fixed-price purchase option

Lessee has a purchase option to acquire the leased property at a fixed price at the end of the lease term. The fixed price is equal to the residual value guarantee amount.

Evaluation

The leased asset, related nonrecourse debt, residual value guarantee and purchase option represent a silo VIE. The equity investors in the residual VIE are entitled to essentially none of the leased asset's returns.

Question 3.7.40

Can a silo VIE exist if the fair value of the specific assets represents more than 50% of the fair value of the legal entity's total assets?

Interpretive response: Yes. A potential silo arises when an interest in specific assets represents essentially the only source of payment for specified liabilities and other interests. We believe an enterprise should apply this guidance even if the fair value of the specific assets represents greater than 50% of the total fair value of the VIE's assets. Although Subtopic 810-10 states that this condition causes an interest to be a variable interest in the legal entity, it does not exempt the interest from potentially being a variable interest in a silo VIE. [810-10-25-55 – 25-58]

However, if the fair value of the potential silo's assets comprises more than 50% of the fair value of the legal entity's total assets, the residual entity includes those assets (and the related interest in those assets) when evaluating whether the entity is a VIE. This is because the only interests that are excluded when constituting the residual entity are interests in specified assets – i.e. assets whose fair value comprises 50% or less of the fair value of the legal entity's total assets (see Question 3.7.10). Inclusion of the potential silo's assets (and the related interest in these assets) typically results in the residual entity being a VIE because the equity-at-risk group is shielded from absorbing expected losses (see Question 3.6.10) [810-10-25-55 – 25-56]

Question 3.7.50

Can a fixed-price purchase option in an operating lease be a variable interest in a silo VIE?

Interpretive response: Yes. A fixed-price purchase option in an operating lease that relates to leased assets is a variable interest in a silo VIE if the residual entity is a VIE and essentially all of the economics of the leased asset and related liabilities and other instruments are segregated. [810-10-25-57 – 25-58]

If the purchase option is not an interest in a silo VIE, it may be an interest in specified assets (section 3.6) if: [810-10-25-55 – 25-56]

- the purchase option relates to leased assets whose fair value comprises 50% or less of the fair value of the lessor's total assets; and
- the lessee has only an insignificant other variable interest in the lessor entity.

If one or both of these conditions are not met, a fixed-price purchase option is a variable interest in the lessor entity. See section 3.4.40 for guidance on evaluating operating leases, and section 3.4.20 for guidance on evaluating derivatives.

Question 3.7.60

What effect do interests in a potential silo have on the variability absorbed by a legal entity's variable interests?

Interpretive response: An interest in a potential silo and the related variability from the assets are excluded from the rest of legal entity when applying the VIE guidance to the residual entity if the fair value of the potential silo's assets comprise 50% or less of the fair value of the legal entity's total assets (see Question 3.7.10). The residual entity is the entity that remains after removing the variability from the potential silo that represents an interest in specified assets (and the related interests in the potential silo). [810-10-25-57]

If the fair value of the potential silo's assets comprises more than 50% of the fair value of the legal entity's total assets, the residual entity includes those assets (and the related interests in those assets) when evaluating whether the entity is a VIE (see Question 3.7.40). This typically results in the residual entity being a VIE because the equity-at-risk group is shielded from absorbing expected losses (see Question 3.6.10) [810-10-25-55 – 25-56]

As discussed in section 3.6, excluding the variability from an interest in specified assets (whether or not it is a potential silo) often results in a lower likelihood that the residual entity is a VIE. For example, excluding the expected losses from a potential leased asset silo results in the residual lessor entity needing less equity at risk to demonstrate that it can finance its operations without additional subordinated financial support (see section 4.3).

However, there are situations in which excluding the variability from interests in specified assets results in the residual entity being a VIE even if the legal entity in its totality otherwise would be a VOE. This is more common when the entire legal entity comprises individual interests in specified assets because the residual entity would be left with no equity at risk (see Question 4.3.70).

If the residual entity is not a VIE, then no silo VIE exists. If no silo VIE exists, the entire legal entity (including the potential silo) is evaluated for consolidation under the VOE consolidation model.

If the residual entity is a VIE, the silo VIE and the 'host VIE' (i.e. the legal entity minus the silo VIE) are separately evaluated under the VIE consolidation guidance. The variable interest holders of the host VIE and the variable interest holders of the silo VIE separately identify which holder, if any, is the primary beneficiary of each.

Analyzing potential silos is more complex when other silo VIEs are also present in the legal entity. This is because silo VIEs are separated from the legal entity when constituting the residual entity (in addition to interests in specified assets as discussed in Question 3.7.10). Question 3.6.30 includes steps that explain how an enterprise analyzes a legal entity when there are interests in specified assets of the legal entity, potential silos in the legal entity, or both.

Question 3.7.70

What effect do interests in a silo VIE have on the variability absorbed by an interest in specific assets of a legal entity?

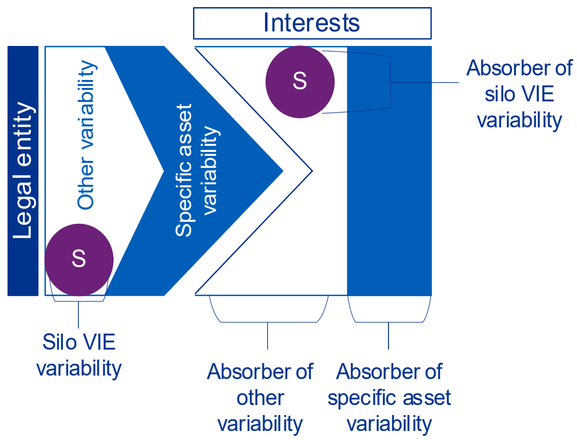
Interpretive response: If a silo VIE exists, an interest in the specific assets of the legal entity that is not related to (or part of) the silo VIE is more likely to be a variable interest in the entity itself.

This is true because the fair value of the host VIE's total assets (i.e. the fair value of the legal entity's total assets minus the fair value of the specified assets) will be lower than the legal entity's total assets (see Question 3.6.30). This results in a greater likelihood that the fair value of the specific assets will comprise more than 50% of the fair value of the host VIE's total assets, making the interest a variable interest in the legal entity itself (see section 3.6). Such an interest would generally result in the host entity being a VIE because the equity-at-risk group is shielded from absorbing the legal entity's expected losses (see Question 3.6.10).

This will be the case even if the interest in specific assets was initially excluded from the legal entity when evaluating whether the potential silo was a silo VIE (see Question 3.7.10).

This situation is illustrated in the following diagram. In the diagram the legal entity includes:

- variability from a silo VIE (purple);
- variability from an interest in specific assets (blue); and
- other variability from the rest of the legal entity's operations and assets (white).



Question 3.7.80

How is the primary beneficiary of a silo VIE determined?

Interpretive response: A silo VIE is accounted for as if it were a separate VIE. As a result, the same requirements that apply in determining the primary beneficiary of a VIE apply in determining the primary beneficiary of a silo VIE.

Chapter 6 explains how to identify a VIE's primary beneficiary. In short, the primary beneficiary of a silo VIE, if any, is the variable interest holder in the silo VIE that possesses both of the following criteria.

A	The power to direct the activities that most significantly impact the silo VIE's economic performance
B	The obligation to absorb losses of the silo VIE or the right to receive benefits from the silo VIE that could potentially be significant to the silo VIE

Question 3.7.90

How does identifying a potential silo affect consolidation procedure?

Interpretive response: The effect of identifying a potential silo on a parent enterprise's consolidation procedure differs depending on whether the residual entity is a VIE or a VOE.

Potential silo in a VOE

If the residual entity (i.e. the legal entity minus interests in specified assets) is not a VIE, then no silo VIE exists. If no silo VIE exists, the entire legal entity (including the potential silo) is evaluated for consolidation under the VOE consolidation model (see Question 3.7.70).

The enterprise that has a controlling financial interest in the VOE, if any, consolidates all of the legal entity's operations, assets, liabilities and NCI – i.e. it includes the operations, assets, liabilities and NCI of the potential silos.

Potential silo in a VIE

If a residual entity (i.e. the legal entity minus interests in specified assets) is a VIE, then the silo VIE and the host VIE (the legal entity minus the silo VIE) are separately evaluated under the VIE consolidation guidance. The silo VIE and the host VIE each individually identify which variable interest holder, if any, is the primary beneficiary (see Question 3.7.60).

The primary beneficiary of the silo VIE, if any, consolidates only the operations, assets, liabilities and NCI of the silo VIE.

The primary beneficiary of the host VIE, if any, consolidates only the operations, assets, liabilities and NCI of the host VIE. We believe the primary beneficiary of the host VIE excludes from its consolidated financial statements the operations, assets, liabilities and NCI of the silo VIE, even if the silo VIE has no primary beneficiary.

3.8 Decision-maker fees

3.8.10 Principal or agent

Excerpt from ASC 810-10

20 Glossary

Decision Maker – An entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity's economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

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

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

>>> Fees Paid to Decision Makers or Service Providers

55-37 Fees paid to a legal entity's **decision maker(s)** or service provider(s) are not variable interests if all of the following conditions are met:

a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
b. Subparagraph superseded by Accounting Standards Update No. 2015-02.
c. The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's **expected losses** or receive more than an insignificant amount of the VIE's **expected residual returns**.
d. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.
e. Subparagraph superseded by Accounting Standards Update No. 2015-02.
f. Subparagraph superseded by Accounting Standards Update No. 2015-02.

55-37A Paragraph superseded by Accounting Standards Update No. 2015-02

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

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

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

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.

55-38 Fees paid to decision makers or service providers that do not meet all of the conditions in paragraph 810-10-55-37 are variable interests.

It is not unusual for the equity investors in a legal entity to delegate decision-making authority to a party that has little or no traditional variable interests in the entity. A decision-maker has a significant impact on the legal entity's economic performance and the variability absorbed by the variable interest holders. In some situations, it may be difficult to determine whether the decision-maker is acting as an agent for the variable interest holders – i.e. in a fiduciary capacity – or as a principal for its own account.

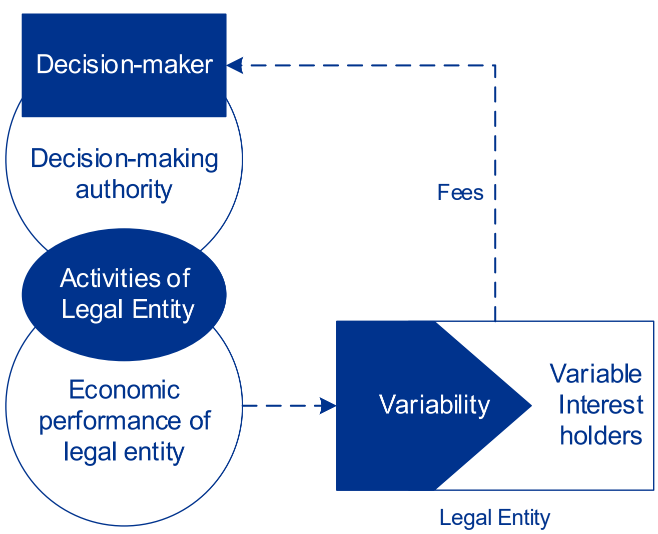
The FASB established conditions that, if met, qualify the decision-maker or service provider (referred to as a 'decision-maker') as an agent. A decision-maker that is an agent does not have a variable interest in the legal entity through its fee arrangement and cannot consolidate the entity.

If the conditions are not met, the decision-maker is considered a principal. A decision-maker that is a principal has a variable interest in a legal entity through its fee arrangement and may need to consolidate the legal entity. [810-10-55-38]

A decision-maker's fee is not a variable interest in a legal entity if: [810-10-55-37, 55-37B]

— its fees are commensurate and customary for the services performed; and

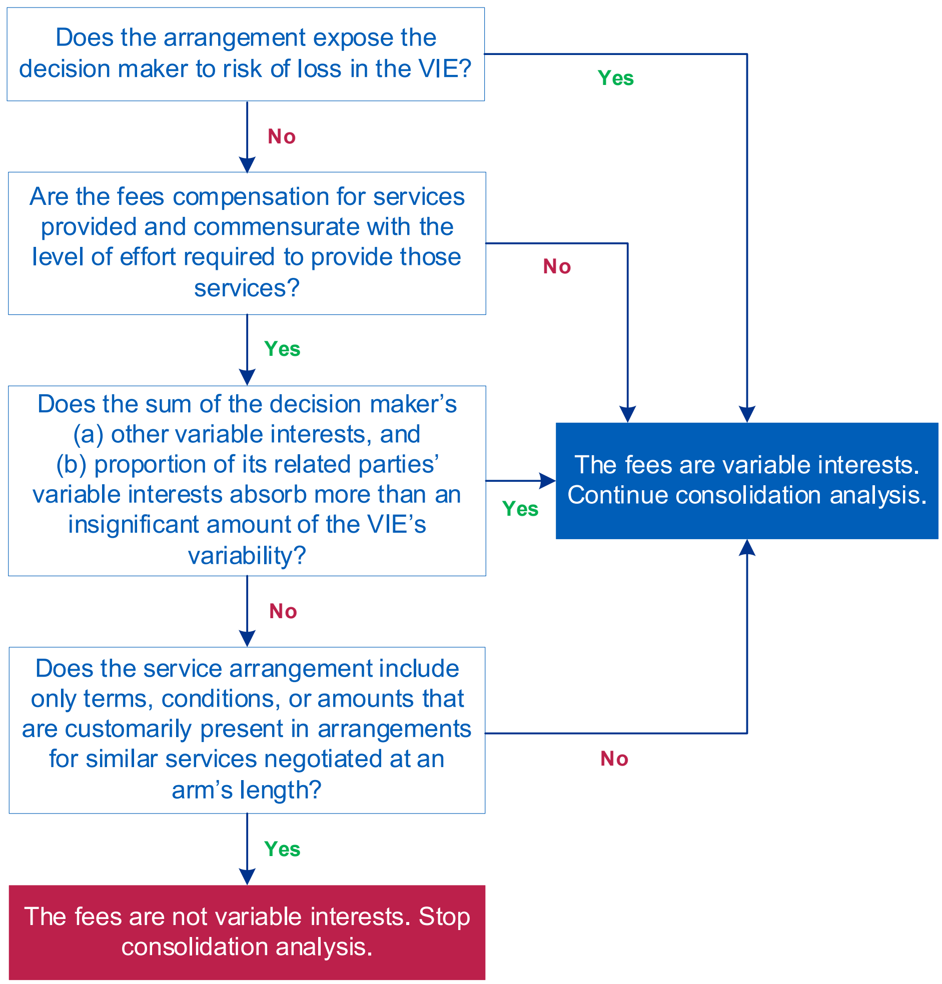
— the aggregate other variable interests held by the decision-maker (and its indirect interests held through its related parties, see section 3.8.20), if any, absorb only an insignificant amount of the legal entity's variability.



Question 3.8.10

How does a decision-maker determine if its fees are variable interests in a legal entity?

Interpretive response: The following decision tree describes how a decision-maker evaluates whether its fees are variable interests.



Fees that expose the service provider to risk of loss include the following (not exhaustive): [810-10-55-37C]

- guarantees of the legal entity's assets or liabilities;
- obligations to fund operating losses;
- written put options on the entity's assets;
- liquidity commitments; and
- other explicit or implicit agreements that protect other interest holders from absorbing the entity's losses.

Question 3.8.20

Are there any circumstances in which a decision-maker can presume that a fee is commensurate and customary?

Interpretive response: Yes. We believe there are two scenarios in which a decision-maker can presume that its fee is commensurate and customary.

Scenario 1	The decision-maker's only involvement with a legal entity is through a fee arrangement.
Scenario 2	The decision-maker holds other interests in the legal entity, but interests of the same class are also held by one or more unrelated parties that do not receive fees from the legal entity.

However, the presumption in both scenarios is generally overcome if the decision-maker fees absorb substantially all of the legal entity's net income, excluding the fees even if there are comparable arrangements in the marketplace.

Question 3.8.30

How does a decision-maker determine whether its fees are commensurate and customary?

Interpretive response: Decision-maker fees are commensurate and customary if they meet both of the following conditions. [810-10-55-37]

1	The fees are commensurate with the services provided and the level of effort required to provide those services.
2	The fees include only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated at arm's-length.

The objective of these conditions is to establish that the fees paid to a decision-maker:

— are compensation only for its services;

— are not affected by any other variable interests that the decision-maker holds in the legal entity – i.e. are consistent with compensation that would be provided to an enterprise that acts solely as a fiduciary or agent; and

— do not convey to the decision-maker substantially all of the legal entity's pre-fee net income.

A conclusion about whether a decision-maker's fee is commensurate, and customary is not based solely on a quantitative analysis – i.e. the magnitude of the fee is not determinative. Instead, a decision-maker uses professional judgment when qualitatively evaluating its individual facts and circumstances.

In some situations, the fee presumptively will **not** represent a variable interest (see Question 3.8.20). In other situations, more analysis is necessary. For example, a decision-maker has involvement with the legal entity other than its fee arrangement – e.g. an interest in the legal entity's Class B shares. The legal entity has issued no other Class B shares to third parties. In this example, we believe further analysis is required to determine whether the arrangement was structured to artificially shift the decision-maker's exposure to the entity's variability from the Class B shares (a variable interest) to the fee arrangement (potentially not a variable interest). Such a shift may inappropriately result in the decision-maker concluding that its fee is not a variable interest if the decision-maker simply presumes the fee is not a variable interest and does not adequately analyze whether the fees are commensurate and customary.

When further analysis is necessary, a decision-maker generally compares:

— its fee arrangement to its other fee arrangements that involve similar services provided to entities in which it has no other interest;

— its fee arrangement to external contracts and business relationships – i.e. those entered into by parties outside of the decision-maker/legal entity relationship; and

— the return profile of its other interests in the legal entity to that of similar interests in other unrelated entities.

The SEC staff has discussed how a decision-maker may evaluate whether its fees are at-market and commensurate (see below). [2015 AICPA Conf]

Excerpt from SEC staff speech

I would also like to address the evaluation of whether a decision-maker's fee arrangement is customary and commensurate.[1] This evaluation is done at inception of a service arrangement or upon a reconsideration event, such as the modification of any germane terms, conditions or amounts in the arrangement.

The determination of whether fees are commensurate with the level of service provided often may be determined through a qualitative evaluation of whether an arrangement was negotiated on an arm's length basis when there are no obligations beyond the services provided to direct the activities of the entity being evaluated for consolidation. This analysis requires a careful consideration of the services to be provided by the decision-maker in relation to the fees.

The evaluation of whether terms, conditions and amounts included in an arrangement are customarily present in arrangements for similar services may be accomplished in ways such as benchmarking the key characteristics of the subject arrangement against other market participants' arrangements negotiated on an arm's length basis, or in some instances against other arm's length arrangements entered into by the decision-maker. There are no bright lines in evaluating whether an arrangement is customary, and reasonable judgment is required in such an evaluation. A decision-maker should carefully consider whether any terms, conditions, or amounts would substantively affect the decision-maker's role as an agent or service provider to the other variable interest holders in an entity.

Christopher D. Semesky, Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments

1 ASC 810-10-55-37.

Question 3.8.40

Is a decision-maker fee automatically a variable interest if there are no similar arrangements in the marketplace?

Interpretive response: No. When no comparable arrangements exist in the marketplace, a decision-maker needs to apply judgment in performing other procedures to evaluate whether its fee arrangement is commensurate and customary. For example, the decision-maker could compare the fee arrangement to its other fee arrangements that involve similar services provided to entities in which it has no other interest (see Question 3.8.30).

If there are no similar external arrangements, a decision-maker fee is not presumptively a variable interest if the fee arrangement: [810-10-55-37B]

— relates to a unique or new service; or
— reflects a change in what is considered customary for the services.

Question 3.8.50

Is an above-market decision-maker fee a variable interest?

Interpretive response: Yes. An above-market fee is not commensurate with the level of effort required to provide those services. [810-10-55-37(a)]

An above-market fee arrangement may also reduce the entity's equity at risk because the above-market component is typically a mechanism to return capital to the decision-maker. See section 4.3 for guidance on equity at risk.

Question 3.8.60

Is a fee arrangement that results in a servicing asset always a variable interest?

Interpretive response: No. Under Topic 860, servicing assets arise when the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the service. Benefits of servicing include revenues from the contractually specified servicing fees, late charges and other ancillary sources, including float. As a result, we believe a servicing asset can arise even if the contractual servicing fee itself is commensurate and customary. [860-50-30-2]

However, servicing assets often arise when the servicer transfers the related financial assets to a securitization vehicle. Transferors/servicers need to exercise significant judgment when determining the effect, if any, that the sale transaction has on the terms of the servicing fee. For example, if the transferor/servicer negotiated lower proceeds for the sale in exchange for an above-market contractual servicing fee, that servicing fee arrangement is not commensurate and customary.

Question 3.8.70

Must a carried interest embedded in a GP's equity interest be considered a decision-maker fee (or part of total decision-maker fees)?

Background: In certain limited partnerships, the GP is entitled to a carried interest or promote (collectively referred to as a 'carried interest'). The carried interest allows the GP to participate in the partnership returns to a greater extent than its proportionate partnership interest. These arrangements are typically structured to align the incentives of the GP as the decision-maker with that of the partnership. Many carried interests are embedded in the terms of the GP's equity interest but may also be issued as separate instruments. They are often settled in cash, with a credit to the GP's capital account or through issuance of additional equity interests. The GP may also receive a separate stated decision-maker fee.

For example, a GP with a 1% partnership interest may receive 20% of a partnership's total distributions after the LPs have received a return of their capital contributions and a specified compounded annual return on their capital contributions.

Interpretive response: No. A GP may choose to characterize a carried interest entirely as a decision-maker fee when evaluating whether it has a variable interest (see Question 3.8.80). However, if it does not make that accounting policy election, it needs to analyze the terms of the carried interest to determine whether it is entirely or partially a decision-maker fee.

— **Part of decision-maker fee.** If the GP cannot transfer its carried interest or its equity interest inclusive of the carried interest and still remain the partnership's decision-maker, the carried interest (or a portion of it) is generally part of the decision-maker fee.

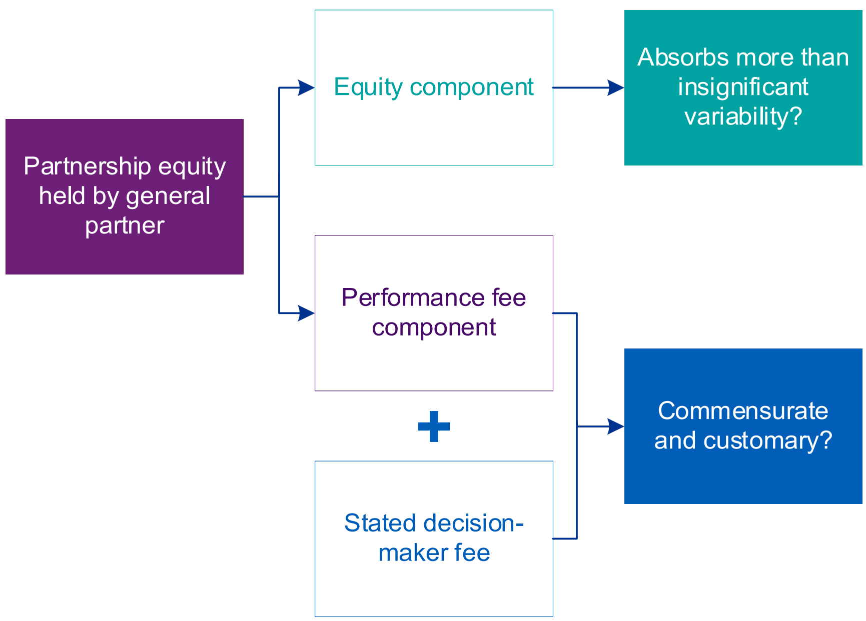
— **Not part of a decision-maker fee.** We believe if the GP (or managing member) can transfer the carried interest, or its equity interest inclusive of the carried interest, and still remain the partnership's decision-maker, the carried interest is generally **not** part of the decision-maker fee. In that circumstance, the carried interest is part of the equity interest.

Lack of information to determine carried interest

In some cases, there may be insufficient information in the partnership's governing agreements or marketing materials to isolate how much of the carried interest is intended to provide the GP with additional compensation for its performance as the decision-maker. We believe one acceptable approach to isolate the fee component from the rest of the equity interest is the residual approach.

Under the residual approach, the portion of the equity or similar interest that is considered a part of the decision-maker fee is the amount that when added to the stated fee paid to the decision-maker, results in a total fee that is commensurate and customary. That portion is called the performance fee component.

If the remaining equity or similar interest – i.e. the equity interest excluding the performance fee component – absorbs more than an insignificant amount of the partnership's variability, the decision-maker fee is a variable interest (see Question 3.8.100). If the GP also holds indirect interests through related parties, those interests are combined with the GP's direct interest when evaluating whether the total interest absorbs more than an insignificant amount of the partnership's variability (see section 3.8.20). [810-10-55-37]



Example 3.8.10 illustrates this guidance.

Question 3.8.80

Does a GP have the option to characterize the entire carried interest as a decision-maker fee?

Interpretive response: Yes. The SEC staff indicated that it would not object to the view that a carried interest may be evaluated as a performance fee instead of an equity interest when assessing whether it is a variable interest under Topic 810.

The staff's comments were made at the April 2016 meeting of the FASB/IASB Revenue Recognition Transition Resource Group in connection with addressing how a GP that does not consolidate a partnership may account for a carried interest after adoption of ASU 2014-09, Revenue from Contracts with Customers. [TRG 04-16.50]

Question 3.8.90

Does a GP include an equity-settled carried interest as an other interest when evaluating its decision-maker fee?

Background: A carried interest may be a stand-alone term in a fee arrangement or embedded in a GP's equity or similar interest. When embedded in the equity interest, it may ultimately be identified, in whole or in part, as part of the decision-maker fee arrangement or the equity interest itself (see Question 3.8.70). A carried interest may be settled with a credit to the GP's capital account or through issuance of additional equity interests.

A commensurate and customary decision-maker fee arrangement is a variable interest in the partnership only if the decision-maker's other interests absorb more than an insignificant amount of the partnership's variability. In this case, the commensurate and customary fee includes the stated fee and the portion of the carried interest that is considered part of the fee arrangement.

Interpretive response: Not necessarily. We do not believe an equity-settled carried interest (or a portion thereof, see Question 3.8.70) can become an other interest in the partnership until the equity is issued.

If and when the capital credit or additional equity interests is issued, we believe it increases the GP's other interests in the partnership only if the following conditions are met:

- the additional capital is not subject to recapture – e.g. if the partnership's performance declines in the future; and
- the GP may transfer its new equity and still remain the partnership's decision-maker.

If these conditions are not met, we believe the additional capital does not increase the GP's other interests in the partnership.

An increase in the GP's other interests triggers a reconsideration of whether the decision-maker fee is a variable interest (see Question 3.8.190). On reconsideration, the additional interest increases the likelihood that the GP's other interests absorb more than an insignificant amount of the partnership's variability.

Example 3.8.20 illustrates this guidance.

Question 3.8.100

Is there a quantitative threshold for 'more than insignificant'?

Interpretive response: No. Subtopic 810-10 does not include a quantitative threshold for what qualifies as a 'more than insignificant' amount when evaluating whether a decision-maker fee is a variable interest.

We believe practice has generally interpreted more than insignificant to mean more than 10%. Therefore, a commensurate and customary decision-maker fee is generally not a variable interest if the decision-maker's other variable interests (excluding the fee arrangement) do not absorb more than 10% of the legal entity's expected variability.

As a decision-maker's other interests (plus its indirect interests held through related parties, see section 3.8.20) approach 10%, the analysis can require more judgment and consideration of the relevant facts and circumstances. In making that judgment, the decision-maker should consider the objective of the analysis – i.e. to determine whether it is acting in a fiduciary capacity on behalf of the variable interest holders.

Examples 3.8.10 to 3.8.30 illustrate this guidance.

Question 3.8.110

Is a decision-maker's fee a variable interest if it cannot be removed through substantive kick-out rights?

Interpretive response: Not necessarily. A decision-maker may conclude that its fee is not a variable interest in the legal entity even if no substantive kick-out rights exist.

A decision-maker's fee is not a variable interest if (see Question 3.8.10): [810-10-55-37, 55-37B]

— its fees are commensurate and customary for the services performed; and

— the aggregate other variable interests held by the decision-maker – and its indirect interests held through its related parties (see section 3.8.20), if any – absorb only an insignificant amount of the legal entity's variability.

A decision-maker that does not have a variable interest cannot consolidate the legal entity.

Examples 3.8.10 and 3.8.20 illustrate this guidance.

Question 3.8.120

If a decision-maker has an equity investment at risk, does it automatically absorb more than an insignificant amount of variability?

Interpretive response: No. We believe a decision-maker may hold a substantive equity investment at risk in a VIE and conclude that the interest does not absorb more than an insignificant amount of variability.

For example, a 1% equity investment at risk may be considered substantive (see Question 4.3.30), but generally does not absorb variability that is more than insignificant to the entity (see Question 3.8.100).

Question 3.8.125

Is an insignificant 'other interest' held by a decision-maker a variable interest even if its fee is not?

Interpretive response: Yes. Although a decision-maker's insignificant other interest (e.g. an equity interest) may not cause its fee to be a variable interest, it could itself be a variable interest. In that case, the decision-maker cannot be the VIE's primary beneficiary (see Question 6.2.80), but it could be subject to the VIE disclosure requirements (see chapter 8).

Question 3.8.130

Is a fee that is computed as a fixed percentage of the legal entity's assets a variable interest if the decision-maker holds no other interests?

Interpretive response: Generally, no. If the fee arrangement (including the rate percentage) is commensurate and customary and the decision-maker has no other variable interests in the legal entity, the fee is generally not a variable interest. Decision-maker fees that are computed as a fixed percentage of the fair value of a legal entity's assets are common in the investment management industry.

The fee arrangement may be a variable interest if the fee absorbs substantially all of the legal entity's net income excluding the fees even if there are comparable arrangements in the marketplace (see Question 3.8.20).

Examples 3.8.10 and 3.8.20 illustrate this guidance.

Example 3.8.10
Investment fund with performance fee paid in cash

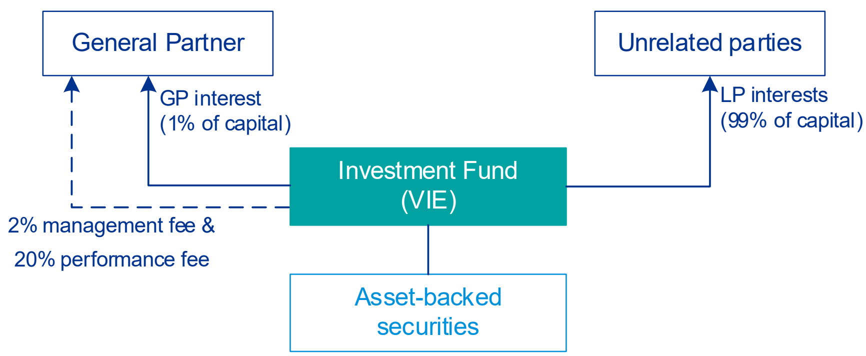
Background

Investment Fund is a VIE created to hold a portfolio of asset-backed securities.

General Partner is the asset manager and contributes nominal capital in exchange for a 1% interest in Investment Fund. General Partner holds no LP interests and has the contractual right to direct the activities that most significantly impact the fund's economic performance.

Multiple unrelated parties hold LP interests that represent 99% of the fund's equity capital. The LPs have no substantive kick-out rights or participating rights over General Partner.

For its services, General Partner earns an annual management fee of 2% of the fund's net asset value and a performance fee (or carried interest). The performance fee is 20% of Investment Fund's profits after the fund has achieved a 10% compounded annual rate of return on total capital contributions. The management and performance fees are commensurate and customary.



Scenario 1: All fees paid in cash

The management and performance fees are paid in cash.

Evaluation

General Partner's decision-maker fees are not variable interests in Investment Fund for the following reasons.

- Management and performance fees are commensurate and customary and do not absorb substantially all of Investment Fund's pre-fee net income (see Question 3.8.130).
- General Partner's 1% equity interest is insignificant (see Question 3.8.100).
- None of the LPs' equity interests need to be considered because the LPs are not related to General Partner (see section 3.8.20).

The fact that the LPs have no substantive kick-out or participating rights does not affect the conclusion (see Question 3.8.110).

General Partner cannot be the primary beneficiary of Investment Fund (see chapter 6). However, General Partner considers the VIE disclosure requirements related to its equity interest.

Scenario 2: Management fee paid in cash; performance fee paid in equity interests – at formation

The management fee is paid in cash. For tax purposes, the performance fee is paid through the issuance of additional equity interests. General Partner may sell or redeem those additional equity interests – i.e. it is not required to hold them to remain the decision-maker.

Evaluation – at formation

General Partner's decision-maker fees are not variable interests in Investment Fund for the following reasons.

— Management and performance fees are commensurate and customary and do not absorb substantially all of Investment Fund's pre-fee net income (see Question 3.8.130);

— General Partner's 1% equity interest is insignificant (see Question 3.8.100).

— None of the LPs' equity interests need to be considered because the LPs are not related to General Partner (see section 3.8.20).

The following facts do not affect the conclusion.

— The LPs have no substantive kick-out or participating rights (see Question 3.8.110).
— The performance fee is paid in equity interests (see Question 3.8.90).

General Partner cannot be the primary beneficiary of Investment Fund (see chapter 6). However, General Partner considers the VIE disclosure requirements related to its equity interest.

Scenario 2: Management fee paid in cash; performance fee in equity interests – two years later

Two years after Investment Fund's formation, General Partner receives a 15% equity interest in the fund as a performance fee. General Partner elects to retain the new equity interest even though it is not required to do so.

Evaluation – two years later

General Partner's decision-maker fee is a variable interest. The increase in General Partner's other interests triggers a reconsideration of whether the decision-maker fee is a variable interest (see Question 3.8.190). The new 15% equity interest increases General Partner's other interests in Investment Fund to an amount that absorbs more than an insignificant amount of the fund's expected variability. General Partner's decision to retain the equity interest is substantively the same as electing to make an equity investment in Investment Fund.

General Partner likely is the primary beneficiary of Investment Fund because its fee arrangement is a variable interest, it has the power to direct the activities that most significantly impact the Investment Fund's performance and absorbs variability that could be significant to Investment Fund (see section 6.6.20).

Example 3.8.20
Investment fund with performance fee allocated to GP capital account

Background

Investment Fund is a VIE created to hold a portfolio of asset-backed securities.

General Partner is the asset manager and contributes nominal capital in exchange for a 1% interest in Investment Fund. In addition to its 1% pro rata allocation of Investment Fund's net income, General Partner also receives additional equity interests equal to 20% of Investment Fund's profits after the fund has achieved a 10% compounded annual rate of return on total capital contributions (the carried interest).

General Partner may not sell its 1% equity interest and remain the decision-maker, but it can sell or redeem the additional equity interests earned. It may also retain them thereby increasing its percentage share of Investment Fund's operating results.

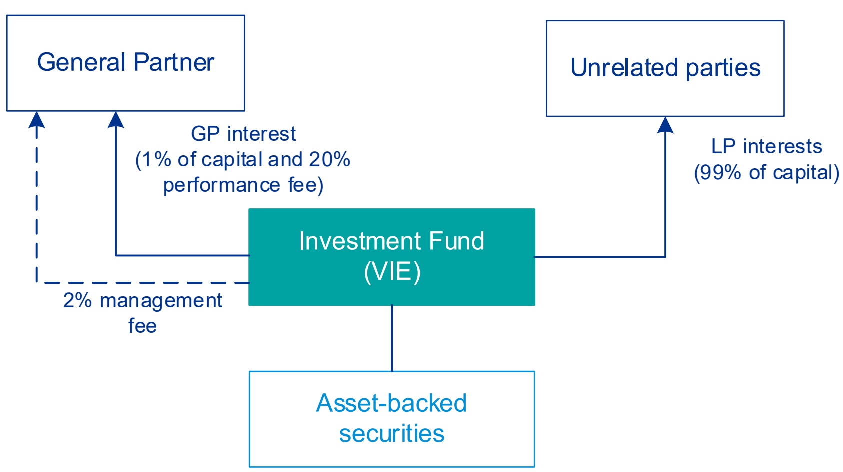
General Partner holds no LP interests and has the contractual right to direct the activities that most significantly impact the fund's economic performance.

Multiple unrelated parties hold LP interests that represent 99% of the fund's equity capital. The LPs have no substantive kick-out rights or participating rights over General Partner.

For its services, General Partner earns an annual management fee of 2% of the fund's net asset value. The management fee is paid in cash.

The combination of the carried interest and the management fee is commensurate and customary for the General Partner's services based on comparisons to other similar asset management arrangements.

Two years after Investment Fund's formation, General Partner receives a 15% equity interest in the fund under the terms of its management agreement. General Partner elects to retain the new equity interest even though it is not required to do so. After the issuance, General Partner is allocated 16% of Investment Fund's operating results – i.e. its new pro rata share.



Evaluation – at formation

General Partner's decision-maker fee is not a variable interest in Investment Fund for the following reasons.

- The decision-maker fee (i.e. the combination of the management fee and the performance fee component embedded in the equity interest) is commensurate and customary and does not absorb substantially all of Investment Fund's pre-fee net income (see Question 3.8.130).
- General Partner's other interest (i.e. its equity interest after removing the performance fee component) is insignificant (see Questions 3.8.70 and 3.8.100).
- None of the LPs' equity interests need to be considered because the LPs are not related to General Partner (see section 3.8.20).

The following facts do not affect the conclusion.

- The LPs have no substantive kick-out or participating rights (see Question 3.8.110).
- The performance fee is paid in equity interests (see Question 3.8.70 and Question 3.8.90).

General Partner cannot be the primary beneficiary of Investment Fund (see chapter 6). However, General Partner considers the VIE disclosure requirements related to its equity interest.

Evaluation – two years later

General Partner's decision-maker fee (i.e. the combination of the management fee and the performance fee component embedded in the equity interest) is a variable interest. The increase in General Partner's other interests triggers a reconsideration of whether the decision-maker fee is a variable interest (see Question 3.8.190). The new 15% equity interest increases General Partner's other interests in Investment Fund to an amount that absorbs more than an insignificant amount of the fund's expected variability. General Partner's decision to retain the equity interest is substantively the same as electing to make an equity investment in Investment Fund.

General Partner likely is the primary beneficiary of Investment Fund because its fee arrangement is a variable interest, it has the power to direct the activities that most significantly impact Investment Fund's performance and absorbs variability that could be significant to Investment Fund (see chapter 6).

Example 3.8.30
Master limited partnership

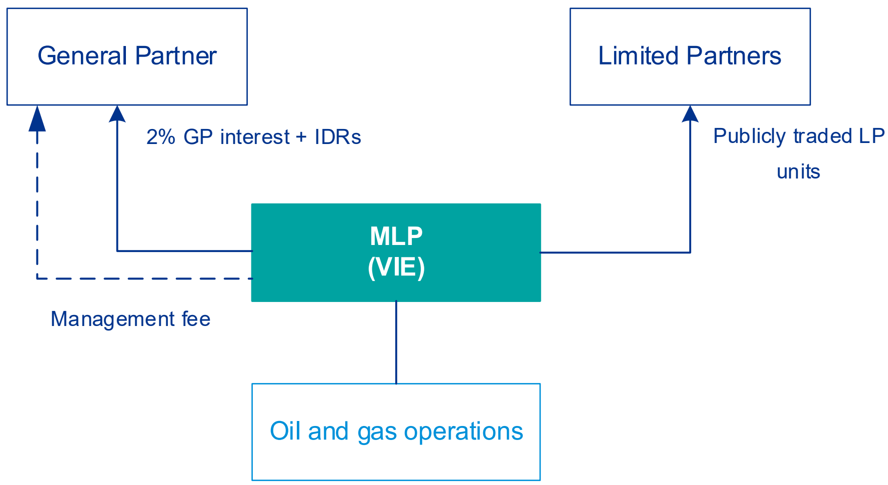
Background

MLP (a master limited partnership) is a VIE formed to own and operate the infrastructure necessary to transport, refine and store oil and gas for end-users.

MLP is managed by General Partner, who is responsible for overseeing the business operations of MLP on behalf of the LPs. General Partner has the contractual right to direct the activities that most significantly impact MLP's economic performance. The LPs have no substantive kick-out rights or participating rights over General Partner and hold LP units that are publicly traded.

General Partner receives an up-front 2% GP interest in MLP. It also receives Incentive Distribution Rights (IDRs) that entitle it to increasingly higher percentages of MLP's incremental cash flows once the payout on the LP units reaches certain predetermined targets – i.e. after the LP units receive a quarterly distribution, the IDRs receive between 2% to 50% of remaining available cash flows. The IDRs are freely transferable to third parties and therefore do not contain a performance fee component. The IDRs are nonvoting if they are held by General Partner and have limited voting rights if held by third parties. The combination of the GP interest and the IDRs absorbs an insignificant amount of MLPs variability.

For its services, General Partner receives ongoing fees for managing MLP's assets. The management fee is commensurate and customary.



Evaluation

General Partner's decision-maker fees are not variable interests in MLP for the following reasons.

- The management fee is commensurate and customary.
- General Partner's other interests (i.e. its 2% equity interest and the IDRs) are insignificant (see Question 3.8.100).
- None of the LPs' equity interests need to be considered because the LPs are not related to General Partner (see section 3.8.20).

The fact that the LPs have no substantive kick-out or participating rights does not affect the conclusion (see Question 3.8.110).

General Partner cannot be the primary beneficiary of MLP (see chapter 6). However, General Partner considers the VIE disclosure requirements related to its equity interest.

Question 3.8.140

Is a cleanup call held by the transferor of financial assets a variable interest in the transferee?

Background: A cleanup call is an option by the servicer or its affiliate (which may be the transferor) to purchase: [860-10 Glossary]

— the remaining transferred financial assets; or

— the remaining beneficial interests not held by the transferor, its affiliates or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity) if the amount of outstanding financial assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

Interpretive response: Generally, no. We believe that if a cleanup call does not preclude the transfer of financial assets from being accounted for as a sale, it is a term of the servicing arrangement. As a result, its terms (including at what point servicing the assets becomes burdensome in relation to the benefits of servicing) should be considered when evaluating whether the servicing fee arrangement is commensurate and customary.

Question 3.8.150

Are a transferor's standard representations and warranties related to the transfer of financial assets variable interests in the transferee?

Background: Standard representations and warranties are those that assert the financial asset being transferred is what it is purported to be at the transfer date. [860-10 Glossary]

Interpretive response: Generally, no. We believe that if a transferor's standard representations and warranties that do not preclude the transfer of financial assets from being accounted for as a sale, it is a term of the servicing arrangement. As a result, the standard representations and warranties should be considered when evaluating whether the servicing fee arrangement is commensurate and customary.

Question 3.8.160

Are servicing advances a variable interest in the transferee?

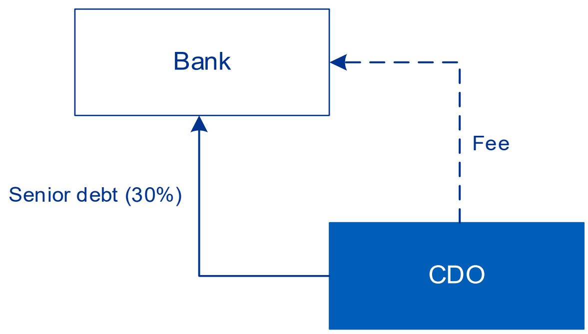
Interpretive response: Generally, no. We believe that a servicing advance is a term of the servicing arrangement and therefore should be considered when evaluating whether the servicing fee arrangement is commensurate and customary.

Question 3.8.170

Is an interest held for market-making purposes evaluated as an other interest in a legal entity?

Background: A decision-maker or service provider may act as a market maker in the securities of a legal entity for which it also provides decision-maker services. As a market maker, the decision-maker acquires the securities on issuance with the intent to sell them – usually into a public market.

For example, assume that Bank receives a base fee equal to a fixed percentage of assets under management and buys a 30% interest in the most senior tranche of debt instruments issued by CDO. Bank is acting as a market maker for the debt – i.e. it holds its investment in CDO's debt securities to facilitate active trading in those securities. Bank plans to resell the debt securities in the near term.



Interpretive response: Yes. The reason why a decision-maker holds the interest (e.g. because it is a market maker) and the expected hold period are generally not relevant in evaluating whether:

— the interest itself is a variable interest; or
— a decision-maker fee arrangement with the issuer of the interest is a variable interest.

Bank needs to evaluate the relevant facts and circumstances to determine whether its investment in CDO's debt securities results in its fee being a variable interest. If 30% of the most senior tranche of CDO's debt securities absorbs only an insignificant amount of CDO's variability and Bank's fee is commensurate and customary, Bank's fee arrangement is not a variable interest.

Bank will likely consider the following when determining whether the amount of variability absorbed by the investment in CDO's debt securities is insignificant:

— the nature of CDO's assets;
— the fair value of the senior debt;
— the fair value of CDO's assets; and
— the variability of CDO absorbed by the subordinated tranches.

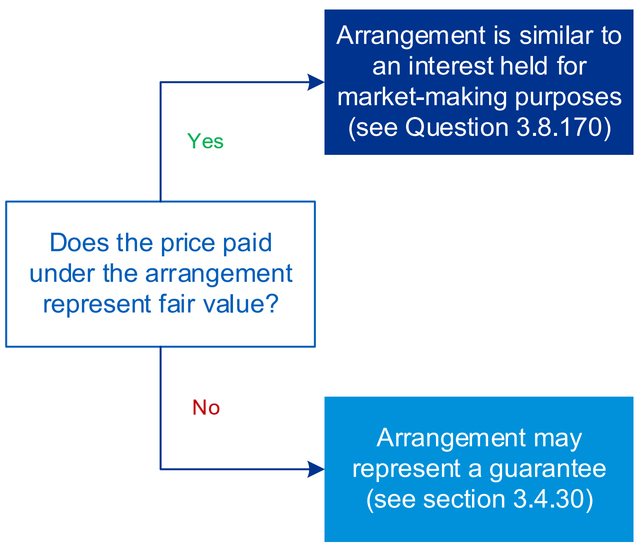
Bank's investment in CDO's debt securities and the fee arrangement are often entered into at or near the same time. Bank should consider whether there are any terms in the market making arrangement that may suggest that the fee arrangement is not commensurate or customary.

Question 3.8.180

Is a contingent liquidity arrangement a variable interest or does it cause a decision-maker fee to be a variable interest?

Background: A decision-maker may enter into a liquidity arrangement with a legal entity that obligates it to acquire some or all of the legal entity's interests on the occurrence of a specified liquidity event.

Interpretive response: It depends. The analysis of whether the liquidity arrangement is a variable interest and whether it causes the decision-maker fee arrangement to be a variable interest depends on whether the purchase price paid represents fair value, as shown in the following diagram.



If the specified price to be paid under the liquidity arrangement is the fair value of the securities, the decision-maker does not have an other interest unless and until it purchases the securities. When the decision-maker purchases the securities, it must reconsider whether the decision-maker fee is a variable interest (see Question 3.8.190). The effect of the new investment is evaluated in the same way any other investment is evaluated – e.g. a market-making investment (see Question 3.8.170).

If the specified price to be paid under the liquidity arrangement is not fair value, the arrangement is similar to a guarantee (see section 3.4.30). As a result, the decision-maker may have an other interest before the occurrence of a liquidity event. If the guarantee-like arrangement is a variable interest, the decision-maker needs to evaluate whether it absorbs more than an insignificant amount of variability. It must do so to determine whether its fee is a variable interest.

When evaluating the significance of the variability absorbed by the liquidity arrangement, the decision-maker likely will consider the likelihood of a liquidity event and the extent to which the price to be paid is expected to exceed the securities' fair value.

Question 3.8.190

When does an enterprise reconsider whether its fee arrangement is a variable interest?

Interpretive response: We believe an enterprise should reevaluate whether a decision-maker fee is a variable interest when: [810-10-35-4]

— it changes its involvement with the entity;
— it reconsiders whether the legal entity is a VIE (see section 4.8); or
— there is a change in the legal entity's design.

Changes in involvement

We believe an enterprise's involvement changes when it renegotiates substantive terms of the fee arrangement. At that time, the decision-maker evaluates whether:

— the renegotiated fees are commensurate and customary; and
— it has other interests that absorb more than an insignificant amount of the legal entity's variability (see Question 3.8.100 and section 3.8.20).

We also believe that a decision-maker should reevaluate whether it has other interests that absorb more than an insignificant amount of the legal entity's variability when it acquires additional interests (or indirect interests through related parties) in the entity or disposes of existing interests in the entity. However, if there is no change to the fee arrangement at that time, we believe the enterprise does not need to reevaluate whether the fee is commensurate and customary.

VIE reconsideration events and changes in design

The events that require reconsideration of whether an entity is a VIE often accompany a change in the legal entity's design – i.e. the risks it was designed to create and distribute to its interest holders. However, those events may not capture all situations in which a change in design may occur.

An enterprise is not required to reconsider whether a VOE is a VIE, or vice versa, just because it incurs losses that are greater than its expected losses. That situation alone does not indicate that there has been a change in design.

Similarly, changes in general market conditions, in isolation, do not suggest a change in design. For example, if an enterprise initially concludes that its fee is not a variable interest, changes in what is considered customary compensation due to market conditions do not cause the fee to become a variable interest.

3.8.20 Interests held through related parties

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Identifying Variable Interests

>>> Fees Paid to Decision Makers or Service Providers

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

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

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

When evaluating whether a decision-maker has other interests that absorb more that an insignificant amount of a legal entity's variability – making its fee a variable interest – it combines: [810-10-55-37D]

— its direct interests in the legal entity; and
— its indirect interests held through related parties.

In this context, 'related parties' include: [810-10-25-43, 55-37D]

— related parties identified in Topic 850 (related parties); and
— de facto agents of the variable interest holder (see section 6.5.20) with the exception of employees and employee benefit plans – unless those

employees and plans are being used to circumvent the VIE consolidation guidance.

The guidance requires the decision-maker to consider indirect interests held through related parties that are under common control on a proportionate basis; this aligns the analysis with the primary beneficiary determination (see section 6.6.20).

Question 3.8.200

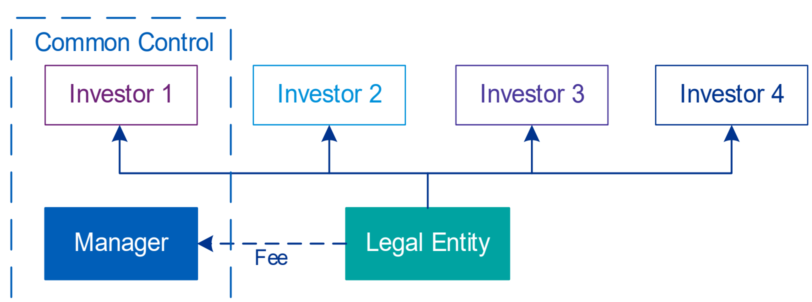
Does a decision-maker include in its 'other interests' interests in the legal entity that are held by related parties if it has no interest in the related party?

Interpretive response: Generally, no. We believe a decision-maker generally includes in its other interests the indirect interests held through related parties only if it holds an economic interest in the related party. An economic interest in a related party includes any variable interest held by the decision-maker – i.e. it is not limited to ownership interests. [810-10-55-37D]

However, there is an exception. We believe a decision-maker includes in its other interests the interests of a related party under common control (see Question 3.8.230) if the common control parent has structured its involvement in that way to avoid consolidation by the decision-maker – i.e. by separating the power from the potentially significant variable interest. We believe this is true even if the decision-maker does not have an interest in the related party under common control.

The determination of whether a related party under common control is being used to separate power from economics to avoid consolidation by the decision-maker often requires significant judgment based on the specific facts and circumstances. However, we believe that arrangements that are not intended to avoid consolidation allow the decision-maker to freely market the legal entity's interests to third-party investors or continue in its role as the decision-maker, even if the related party under common control does not hold an interest in the legal entity.

The SEC staff has discussed how interests held by related parties under common control with the decision-maker should be considered in determining whether a decision-maker's fee is a variable interest (see below). The following diagram illustrates the SEC staff's scenario. [2015 AICPA Conf]



Excerpt from SEC staff speech

The next topic I would like to address is the evaluation of whether a decision-maker's fee constitutes a variable interest under the FASB's updated consolidation guidance.[1] After considering a number of questions posed by registrants, I would like to share with you several observations regarding implementation of the new guidance.

For purposes of illustration consider an entity that has four unrelated investors with equal ownership interests, and a manager that is under common control with one of the investors. The manager has no direct or indirect interests in the entity other than through its management fee, and has the power to direct the activities of the entity that most significantly impact its economic performance.

In this simple example, if the manager's fee would otherwise not meet the criteria to be considered a variable interest, the fact that an investor under common control with the manager has a variable interest that would absorb more than an insignificant amount of variability would not by itself cause the manager's fee to be considered a variable interest. The guidance to consider interests held by related parties when evaluating whether a fee is a variable interest specifically refers to instances where a decision-maker has an indirect economic interest in the entity being evaluated for consolidation.[2] However, in the instance where a controlling party in a common control group designs an entity in a way to separate power from economics for the purpose of avoiding consolidation in the separate company financial statements of a decision-maker, OCA has viewed such separation to be non-substantive.

In my example, if the manager determines that its fee is not a variable interest the amendments in ASU 2015-2 are not intended to subject the manager to potential consolidation of the entity. In other words, a decision-maker would not be required to consolidate through application of the related party tiebreakers once it determines that it does not have a variable interest in the entity.

Christopher D. Semesky, Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments

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1 ASU 2015-2, Consolidation (Topic 810) – Amendments to the Consolidation Analysis, was released in February 2015 and early adoption was permitted, including in an interim period.
2 ASC 810-10-55-37D

Example 3.8.40

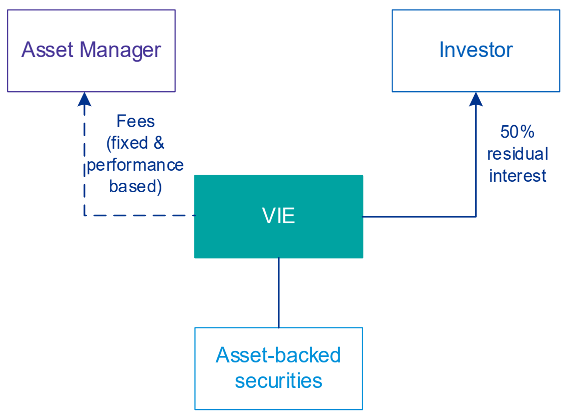
Related party under common control – no indirect interest

Background

VIE is created to hold a portfolio of asset-backed securities and is financed with multiple classes of debt and nominal equity. Investor owns 50% of VIE's residual interests.

Asset Manager is the decision-maker and for its services earns base, fixed-senior and subordinated fees, and a performance-based fee whereby it receives a portion of VIE's profits above a targeted return. The fees are commensurate and customary. Asset Manager does not hold any of VIE's debt or equity and has the power to direct the activities that most significantly impact VIE's economic performance.

Investor is under common control (see Question 3.8.230) with Asset Manager.



Evaluation

Asset Manager's fee arrangement is not a variable interest in VIE because:

- its fee is commensurate and customary; and
- it has no other interest in VIE's variability.

Asset Manager cannot be the primary beneficiary of VIE (see chapter 6).

Asset Manager has no other interest because it includes Investor's interest as its own (a related party under common control) only if:

- it has an economic interest in Investor, or
- Investor's interest in VIE was made so that Asset Manager could avoid consolidating VIE.

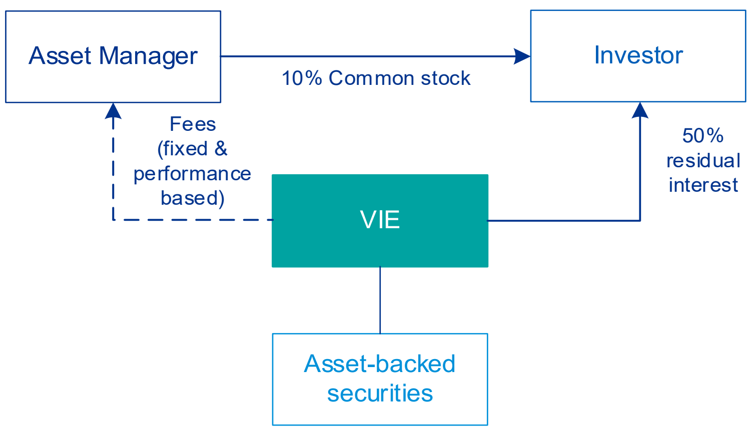
Example 3.8.50
Related party holds an interest in decision-maker

Background

VIE is created to hold a portfolio of asset-backed securities and is financed with multiple classes of debt and nominal equity. Investor owns 50% of VIE's residual interests.

Asset Manager is the decision-maker. For its services, it earns base, fixed-senior and subordinated fees, and a performance-based fee whereby it receives a portion of VIE's profits above a targeted return. The fees are commensurate and customary. Asset Manager does not hold any of VIE's debt or equity and has the power to direct the activities that most significantly impact VIE's economic performance.

Investor owns 10% of Asset Manager's common stock. Investor is a related party to, but not under common control with (see Question 3.8.230), Asset Manager.



Evaluation

Asset Manager's fee arrangement is not a variable interest in VIE because:

— its fee is commensurate and customary; and
— it has no other interest in VIE's variability.

Asset Manager cannot be the primary beneficiary of VIE (see chapter 6).

Asset Manager has no other interest because it includes Investor's interest as its own (a related party under common control) only if:

— it has an economic interest in Investor, or
— Investor's interest in VIE was made so that Asset Manager could avoid consolidating VIE.

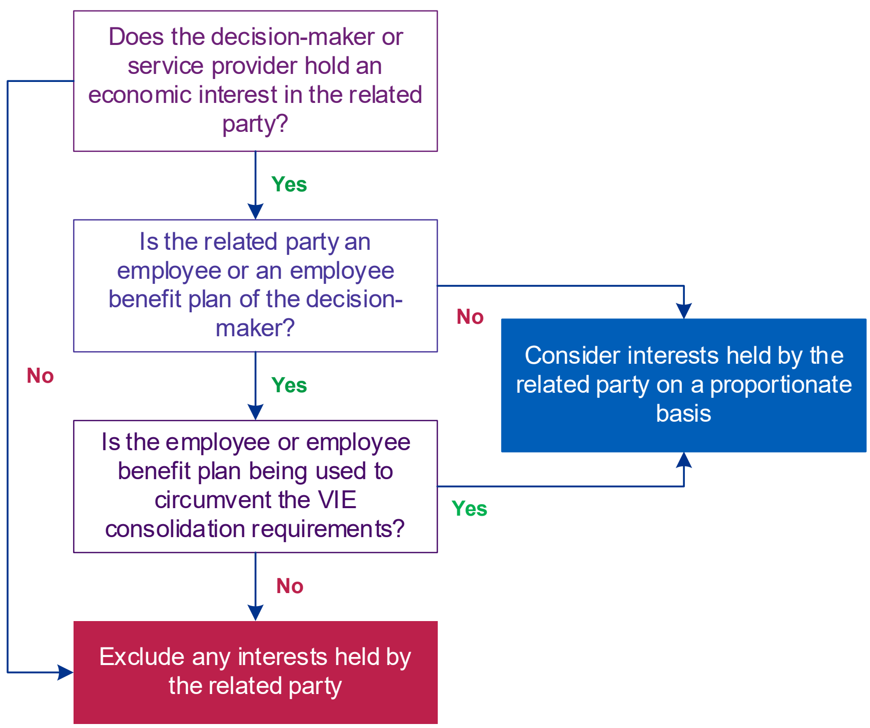
Question 3.8.210#

How does a decision-maker determine its indirect interest held through related parties?

Interpretive response: A decision-maker determines its indirect interest held through all related parties (regardless of whether they are under common control) on a proportionate basis. For example, if a decision-maker owns 10% of a related party and the related party owns 20% of the legal entity, the decision-maker has a 2% indirect interest in the legal entity though its related party. The decision-maker adds that indirect interest to its direct interest and evaluates whether the total absorbs more than an insignificant amount of variability (see Question 3.8.100). If it does, the decision-maker's fee arrangement is a variable interest in the legal entity.

A decision-maker generally includes in its other interests the indirect interests held through related parties only if it holds an economic interest in the related party (see Question 3.8.200). If the economic interest in a related party is other than common equity (e.g. preferred stock or convertible debt) the decision-maker needs to exercise judgment in determining the amount of its indirect interest. The decision-maker may need to determine its share of the related party's expected losses and expected residual returns and the related party's share of the legal entity's expected losses and expected residual returns.

The following decision tree describes how a decision-maker considers its indirect interests held through related parties.



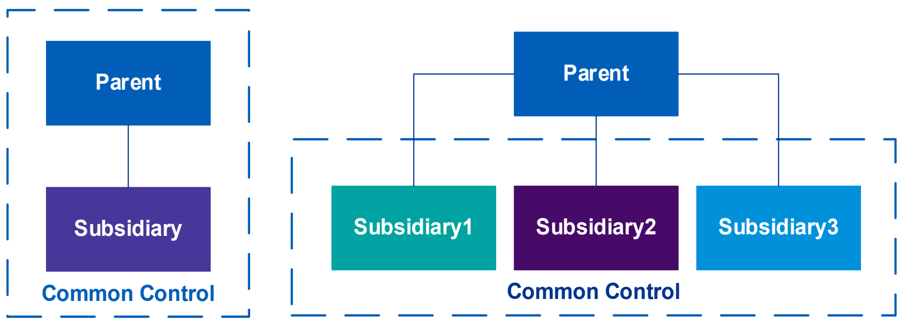
Question 3.8.230

When is a decision-maker under common control with a related party?

Interpretive response: US GAAP does not define common control. The FASB believes a decision-maker is under common control with a related party if it: [ASU 2015-02.BC69]

— directly or indirectly controls the related party; or
— is directly or indirectly controlled by the same party as the related party.

The following diagram illustrates these common-control groups.



Further, although it was never finalized or codified, we believe the guidance in EITF Issue No. 02-5 (Definition of 'Common Control' in Relation to FASB Statement No. 141) is relevant for a decision-maker to consider when identifying related parties under common control.

The following table summarizes the two other common control situations identified in the EITF Issue.

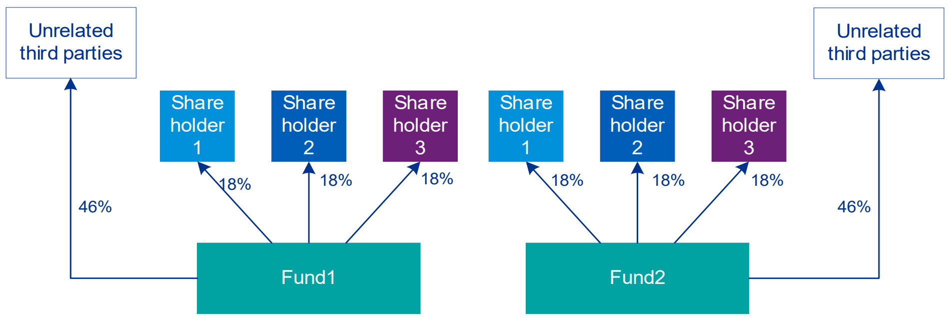
Immediate family members collectively hold a controlling financial interest in each entity	Entities might be owned in varying combinations among living siblings and their children. Those situations require careful consideration regarding the substance of the ownership and decision-making relationships. Absent evidence that the family members will exercise their decision-making rights in any way other than in concert, common control may exist when immediate family members collectively hold a controlling financial interest in each entity. Immediate family members include a married couple and their children, but not the married couple's grandchildren
Explicit agreement	A group of shareholders that hold a controlling financial interest in each entity may have contemporaneous written evidence of an agreement to exercise their decision-making rights in concert. As a result of this explicit agreement, common control exists.

Example 3.8.60
Common control – common shareholder group

Background

Shareholder1, Shareholder2 and Shareholder3 each hold 18% of the voting interests in Fund1. They also each hold 18% of the voting interests in Fund2. The remaining 46% of the voting interests in Fund1 and Fund2 are widely dispersed among unrelated parties.

Shareholder1, Shareholder2 and Shareholder3 are not related parties and have no agreement to vote in concert.



Evaluation

Fund1 and Fund2 are not under common control. Although a common group of shareholders holds a controlling financial interest in each fund, there is no agreement to exercise their decision-making interests in concert.

Example 3.8.70#
Common control – common GP

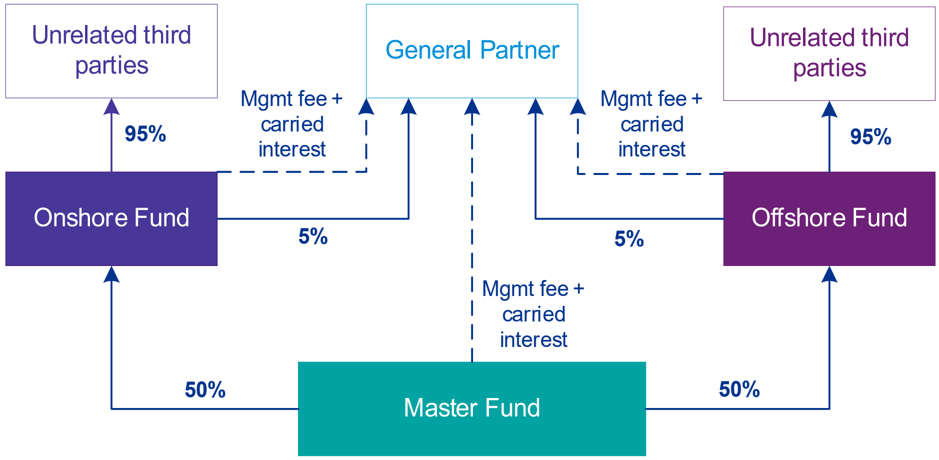
Background

Master Fund was formed to invest in a portfolio of asset-backed securities and provide investment opportunities for US and foreign investors.

Onshore Fund and Offshore Fund each own 50% of Master Fund. For tax purposes, US investors invest in Onshore Fund and foreign investors invest in Offshore Fund. There are no other investors in Master Fund.

General Partner is the GP of Onshore Fund, Offshore Fund and Master Fund. General Partner receives management fees and a carried interest. Its fees are commensurate and customary. General Partner holds a 5% ownership interest in Onshore Fund and a 5% ownership interest in Offshore Fund.

All funds are VIEs.



Evaluation

Onshore Fund and Offshore Fund

General Partner's fee arrangement is not a variable interest in Onshore Fund or Offshore Fund because:

- its fee is commensurate and customary; and
- its other interest (5%) absorbs only an insignificant amount of the funds' variability.

General Partner cannot be the primary beneficiary of Onshore Fund or Offshore Fund (see chapter 6).

General Partner cannot be the primary beneficiary of Master Fund (see chapter 6). General Partner's fee arrangement is not a variable interest in Master Fund because:

- its fee is commensurate and customary; and
- its other interests (5%) absorb only an insignificant amount of Master Fund's variability.

General Partner computes its 5% other interests as follows.

$$\text{Indirect interest through Onshore Fund} = 5\% \times 50\% = 2.5\%$$
$$+$$
$$\text{Indirect interest through Offshore Fund} = 5\% \times 50\% = 2.5\%$$
$$= 5\%$$

General Partner includes in its other interests in Master Fund the indirect 5% interest in Master Fund, regardless of whether it is under common control with Onshore Fund or Offshore Fund.

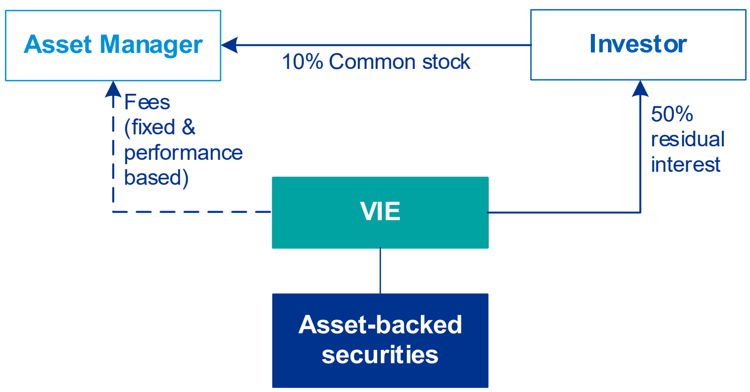
Example 3.8.80#
Related party not under common control with a decision-maker

Background

VIE is created to hold a portfolio of asset-backed securities and is financed with multiple classes of debt and nominal equity. Investor owns 50% of VIE's residual interests.

Asset Manager is the decision-maker and for its services earns base, fixed-senior and subordinated fees, and a performance-based fee whereby it receives a portion of VIE's profits above a targeted return. The fees are commensurate and customary. Asset Manager does not hold any of VIE's debt or equity and has the power to direct the activities that most significantly impact VIE's economic performance.

Asset Manager owns 10% of Investor's common stock. Investor is a related party to, but not under common control with, Asset Manager.



Evaluation

Asset Manager cannot be the primary beneficiary of VIE (see chapter 6). Asset Manager's fee arrangement is not a variable interest in VIE because:

- its fee is commensurate and customary; and
- its other interest (5%) absorbs only an insignificant amount of VIE's variability.

Asset Manager computes its 5% other interest as 10% (its interest in Investor) × 50% (Investor's interest in VIE).

Asset Manager includes in its other interests in VIE the indirect 5% interest in VIE, regardless of whether it is under common control with Investor.

Question 3.8.240

Does a decision-maker include in its other interest its indirect interest held through de facto agents?

Interpretive response: Generally, yes. A decision-maker includes in its other interests those indirect interests that are held through its de facto agents (see section 6.5.20), but only if the decision-maker holds an economic interest in the de facto agent (see Question 3.8.200).

However, there are exceptions for indirect interests held by employees and employee benefit plans. A decision-maker does not include those indirect interests when evaluating its fees unless the employees or plans are being used in an effort to circumvent the VIE consolidation guidance. Section 6.5.20 discusses how an employer with a variable interest considers its employees when identifying the primary beneficiary, if any. [810-10-55-37D]

Question 3.8.250

How should an insurance enterprise evaluate whether to consolidate an entity that is also owned by a separate account in which the enterprise's related parties hold an interest?

Background: A 'separate account' is a separate investment account established and maintained by an insurance enterprise under relevant state insurance law to which funds are allocated for certain contracts of the insurance entity or similar accounts used for foreign originated products. When assessing whether an insurance enterprise is required to consolidate an investment held by a separate account, an insurer typically does not: [944-80-25-3(e)]

— consider any separate account interests held for the benefit of policy holders to be the insurer's interests; or
— combine any separate account interests held for the benefit of policy holders with the insurer's general account interest in the same investment.

However, separate account interests held for the benefit of a related party policy holder are combined with the insurer's general account interest when considering the related party VIE consolidation guidance. [944-80-25-3(f)]

Interpretive response: Topic 944 requires an insurer to apply the related party guidance included in this section if the separate account interests are held for the benefit of related party policy holders. This could affect the analysis for determining:

— whether an insurer has a variable interest in an investment held by a separate account; and
— the primary beneficiary of an investment held by a separate account.

If the insurer holds an economic interest in a related party policy holder in the separate account, it includes in its other interests its indirect interest in the separate account's investment held through the related party.

4. Is the legal entity a VIE?

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

Examples

Examples

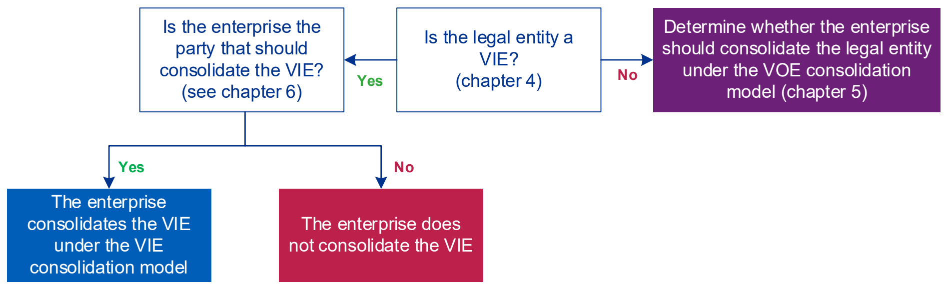
Examples

4.1 How the standard works

An enterprise evaluates whether a legal entity is a VIE only after it determines the following:

— the legal entity is in the scope of the VIE Subsections of Subtopic 810-10 (see chapter 2); and
— The enterprise has a variable interest in the legal entity (see chapter 3).

This evaluation leads to the following results:



Whether a legal entity is a VIE focuses on the amount and characteristics of its equity. If a legal entity's equity has any one of the following five characteristics, then it is a VIE.

First characteristic	Legal entity's equity investors do not have sufficient equity at risk for the legal entity to finance its activities without additional subordinated financial support.	See section 4.3
Second characteristic	As a group, the equity-at-risk investors (collectively, the 'equity-at-risk group') lack the power, through voting or similar rights, to direct the activities that most significantly impact the legal entity's economic performance.	See section 4.4
Third characteristic	The equity-at-risk group is not obligated to absorb the legal entity's expected losses.	See section 4.5
Fourth characteristic	The equity-at-risk group does not have the right to receive the legal entity's expected residual returns.	See section 4.6
Fifth characteristic	The individual equity investors' voting rights are disproportionate to their economic interests in the legal entity and substantially all of the legal entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights.	See section 4.7

An enterprise is not required to reconsider whether a VOE is a VIE, or vice versa, during each reporting period. Reconsideration is required only when certain events occur that may indicate the legal entity's design has changed. The reconsideration events included in Subtopic 810-10 are intended to capture circumstances that indicate there may have been a change in the design of the entity (see section 4.8).

4.2 Overview

Excerpt from ASC 810-10

General

05-3 Throughout this Subtopic, any reference to a **limited partnership** includes limited partnerships and similar **legal entities**. A *similar legal entity* is an entity (such as a limited liability company) that has governing provisions that are the functional equivalent of a limited partnership. In such entities, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner.

Variable Interest Entities

> Consolidation of VIEs

05-08 The Variable Interest Entities Subsections clarify the application of the General Subsections to certain **legal entities** in which equity investors do not have sufficient equity at risk for the legal entity to finance its activities without additional **subordinated financial support** or, as a group, the holders of the equity investment at risk lack any one of the following three characteristics:

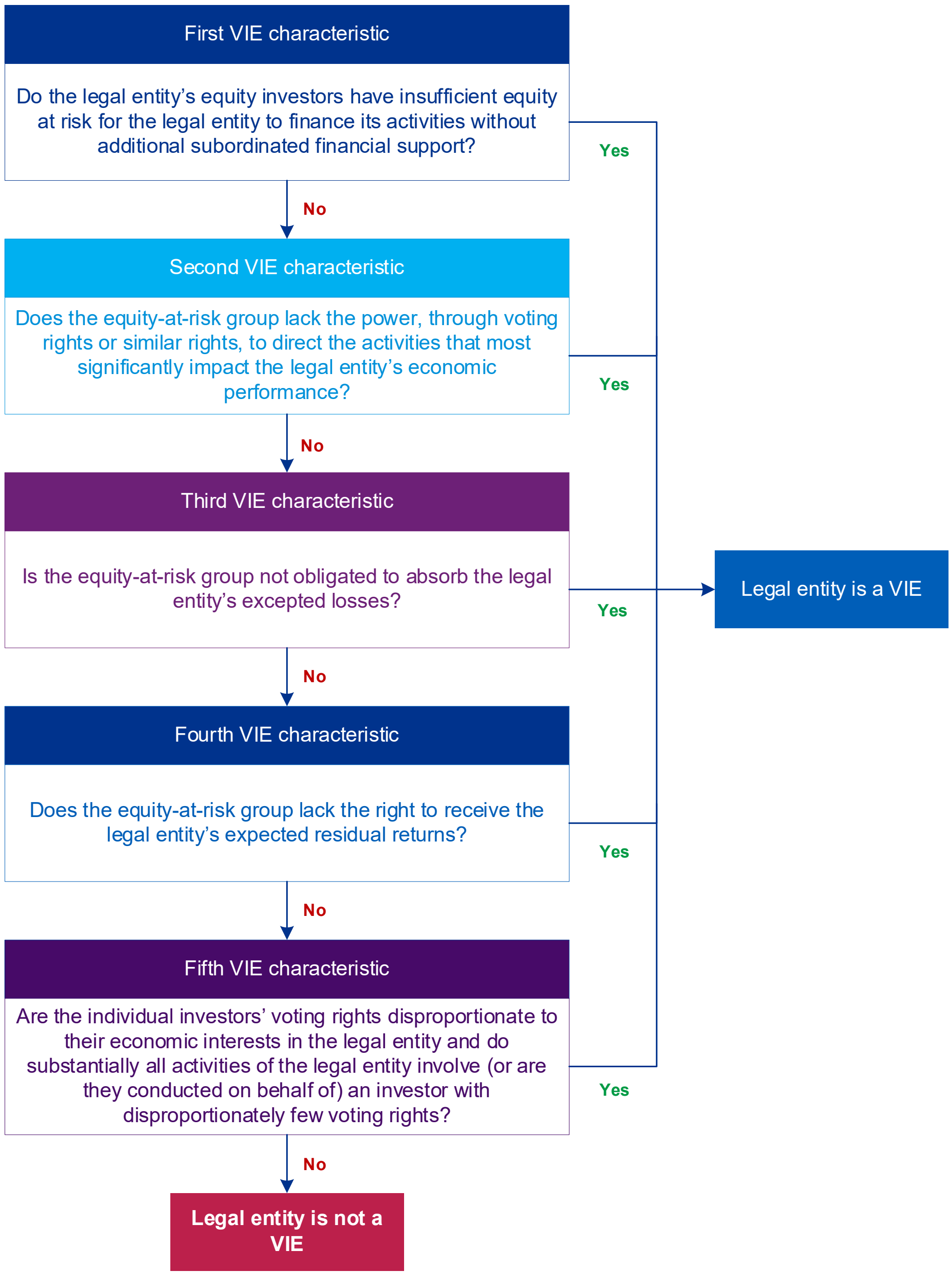
a. The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance
b. The obligation to absorb the **expected losses** of the legal entity
c. The right to receive the **expected residual returns** of the legal entity.

Paragraph 810-10-10-1 states that consolidated financial statements are usually necessary for a fair presentation if one of the entities in the **consolidated group** directly or indirectly has a controlling financial interest in the other entities. For legal entities other than limited partnerships, paragraph 810-10-15-8 states that the usual condition for a controlling financial interest is ownership of a majority voting interest. For limited partnerships, paragraph 810-10-15-8A states that the usual condition for a controlling financial interest is ownership of a majority of the limited partnership's **kick-out rights** through voting interests. However, application of the majority voting interest and kick-out rights requirements in the General Subsections of this Subtopic to certain types of entities may not identify the party with a controlling financial interest because the controlling financial interest may be achieved through arrangements that do not involve voting interests or kick-out rights.

> Initial Involvement with a Legal Entity

25-37 The initial determination of whether a legal entity is a VIE shall be made on the date at which a reporting entity becomes involved with the legal entity. For purposes of the Variable Interest Entities Subsections, involvement with a legal entity refers to ownership, contractual, or other pecuniary interests that may be determined to be variable interests. That determination shall be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements.

If a legal entity's equity has at least one of the five VIE characteristics, then the legal entity is a VIE. [810-10-05-05, 810-10-15-14]



An enterprise determines whether a legal entity's equity possesses these characteristics as soon as it becomes involved with the legal entity in which it has a variable interest. It subsequently reassesses the VIE status if certain triggering events occur that indicate that the entity's design has changed. [810-10-25-37]

Question 4.2.10
What constitutes involvement with a legal entity?

Interpretive response: Involvement means any kind of economic interest in the legal entity; it is not limited to interests in the form of equity or debt investments. Examples of involvement also include management and service contracts, guarantees, derivatives and leases. [810-10-25-37]

However, from a practical perspective, an enterprise only needs to evaluate a legal entity when the enterprise's involvement constitutes a variable interest (see chapter 3), and then only if a scope exception does not apply (see chapter 2).

Question 4.2.20
What effect do potential future changes to a legal entity's equity have on the entity's VIE status?

Interpretive response: An enterprise determines whether a legal entity is a VIE based on the amount and characteristics of the legal entity's equity as explained in subsequent sections of this chapter. The determination is made at the time an enterprise becomes involved with a legal entity and is based on the legal entity's existing governing documents and contractual arrangements. This includes future changes that are required by those documents and arrangements, which typically affect the characteristics of the entity's equity.

Although an enterprise should consider required future changes in the legal entity's design, we believe it should not consider the entity's right to make capital calls on its equity investors. We believe an enterprise should evaluate the sufficiency of equity at risk based on the amount of the entity's equity at the time it becomes involved. If the entity subsequently makes capital calls and the amounts received are then included in the entity's US GAAP equity, the enterprise reassesses whether the entity is a VIE. [810-10-25-37]

Example 4.2.10
Future changes to a legal entity's capital structure

Enterprise, a fast-food restaurant franchisor, provides a subordinated loan to Legal Entity, the developer of a proprietary point-of-sale system that will speed the customer ordering process.

At the time the loan is extended, Legal Entity's equity at risk is not sufficient to absorb its expected losses. However, within three months of the loan's origination, Legal Entity is expected to receive a new round of equity financing from a venture capital firm. The additional equity is expected to be sufficient to absorb Legal Entity's expected losses, meaning Legal Entity will not need to finance its activities with additional subordinated financial support.

Although Legal Entity anticipates that it will receive the future round of equity financing when it obtains the loan from Enterprise, Enterprise may consider only the circumstances that exist at the time the loan is entered into. Therefore, Legal Entity is a VIE when it receives the loan because it has insufficient equity at risk, which is the first characteristic of a VIE.

When Legal Entity obtains the additional equity financing, Enterprise reconsiders Legal Entity's VIE status. At that time Enterprise concludes that Legal Entity no longer possesses the first characteristic. Enterprise then needs to determine whether Legal Entity possesses any of the other four VIE characteristics. If not, Legal Entity would no longer be a VIE.

Question 4.2.30

Is there a significance threshold below which an enterprise does not need to determine whether a legal entity is a VIE?

Interpretive response: No. However, like other topics, the guidance in Topic 810 does not need to be applied to immaterial items. Nevertheless, unless a scope exception applies, we believe that it usually will be necessary for enterprises to evaluate whether they have a variable interest in legal entities with which they are involved and, if so, whether the legal entities are VIEs.

4.3 First VIE characteristic: Insufficient equity at risk

Excerpt from ASC 810-10

Variable Interest Entities

> Entities

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase *by design* refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.)

a. The total equity investment (equity investments in a legal entity are interests that are required to be reported as equity in that entity's financial statements) at risk is not sufficient to permit the legal entity to finance its activities without additional **subordinated financial support** provided by any parties, including equity holders. For this purpose, the total equity investment at risk has all of the following characteristics:
   1. Includes only equity investments in the legal entity that participate significantly in profits and losses even if those investments do not carry voting rights

2. Does not include equity interests that the legal entity issued in exchange for subordinated interests in other VIEs
3. Does not include amounts provided to the equity investor directly or indirectly by the legal entity or by other parties involved with the legal entity (for example, by fees, charitable contributions, or other payments), unless the provider is a **parent**, **subsidiary**, or affiliate of the investor that is required to be included in the same set of **consolidated financial statements** as the investor
4. Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the legal entity or by other parties involved with the legal entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

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

4.3.10 Overview

The first characteristic of a VIE is that the legal entity does not have sufficient equity at risk to finance its activities without additional subordinated financial support. Applying this characteristic is a three-step process. [810-10-15-14(a)]

Step 1	Identify the investments in the legal entity that are equity under US GAAP.
Step 2	Determine which of those identified equity investments are considered at risk.
Step 3	Determine whether the equity at risk is sufficient for the legal entity to finance its activities without additional subordinated financial support.

4.3.20 Step 1: Identifying investments in the legal entity that are equity under US GAAP

Only investments that are equity under US GAAP are considered in determining whether a legal entity is a VIE. [810-10-15-14(a)]

Question 4.3.10

What investments are equity under US GAAP?

Interpretive response: Equity investments for purposes of VIE identification "are interests that are required to be reported as equity in the legal entity's financial statements." An investment would not necessarily be reported as equity under US GAAP simply because it is equity in legal form or has characteristics that are similar to equity (e.g. subordinated debt). [810-10-15-14(a)]

For example, mandatorily redeemable preferred stock is required to be reported as a liability under Topic 480 (liabilities vs equity) and therefore is not considered an equity investment when evaluating whether a legal entity is a VIE. In contrast, preferred stock classified as temporary equity in the legal entity's financial statements (see Section 480-10-S99) is considered an equity investment under US GAAP.

However, depending on the entity's design, interests that are not reported as equity under US GAAP typically represent variable interests in the entity (see chapter 3).

4.3.30 Step 2: Determining which equity investments are at risk

After identifying the US GAAP equity investments in a legal entity, an enterprise then determines whether each of those investments are considered at risk. To be considered at risk, an equity investment must meet all of the following requirements (the at-risk requirements): [810-10-15-14(a)(1) – 15-14(a)(4)]

First at-risk requirement	Equity investment participates significantly in profits and losses.
Second at-risk requirement	Equity investment was not issued in exchange for subordinated interests in other VIEs.
Third at-risk requirement	Equity investment has not been provided directly or indirectly to the equity investor by the legal entity or parties involved with the legal entity.[1]
Fourth at-risk requirement	Equity investment was not financed for the equity investor directly by the legal entity or parties involved with the legal entity.[1]

Note:

1. Requirements 3 and 4 can be met when the equity investment has been provided or financed by a party involved with the legal entity as long as that party is a parent, subsidiary or affiliate of the investor that is required to be included in the same consolidated financial statements as the investor.

Each equity instrument is separately evaluated against these requirements to determine whether it is considered an equity investment at risk.

Question 4.3.20
What are some common examples of equity investments that may be considered at risk?

Interpretive response: Common examples of equity investments that may be considered at risk on further evaluation are:

— common stock (voting and nonvoting);
— various types of perpetual preferred stock that significantly participate in an entity's profits and losses;
— LLC member interests;
— GP and LP interests;
— preferred stock classified in temporary equity under SEC Accounting Series Release No. 268 (ASR 268) Presentation in Financial Statements of "Redeemable Preferred Stocks";
— warrants to purchase equity interests; and
— certain forms of trust beneficial interests.

Before concluding that an equity investment is at risk, an enterprise must review the investment’s features to verify that the investment meets all of the at-risk requirements.

We do not believe the following interests are equity investments at risk under US GAAP:

— capital calls or other subscription arrangements (i.e. unfunded amounts);
— commitments to fund equity;
— commitments to fund losses; and
— obligations to absorb losses.

Question 4.3.30

Is the amount or proportion of a legal entity's equity that an investor holds relevant in determining whether the investment is at risk?

Interpretive response: We believe an individual investor's equity investment must be substantive for it to be considered at risk. In evaluating whether the investor has made a substantive investment, we believe the amount of the investment is more important than the proportion of the investment to the entity's total equity.

For example, if a legal entity has $100 of equity, an equity investment that represents 50% of the entity's total equity is a nominal ($50) investment. In this example, we believe the investor does not have an equity investment at risk because the amount is not substantive even though the investment is significant in proportion to the entity's total equity.

Conversely, if a legal entity has $400 million of equity, an investor with an equity investment that represents 0.25% of the entity's total equity (i.e. $1 million investment) is substantive. In this example, we believe the equity investment can be at risk (if the four at-risk requirements are met) even though the investor's equity investment is not a significant portion of the entity's total equity.

Question 4.3.40

What does participation in profits and losses mean for purposes of the first at-risk requirement?

Interpretive response: Under the first at-risk requirement, equity investments in a legal entity must participate significantly in the entity's profits and losses to be included in the amount of equity at risk. We believe participation in profits and losses is not based on the concept of expected losses and expected residual returns under Subtopic 810-10. Instead, profits and losses in this context is interpreted to mean profits and losses for US GAAP reporting purposes.

This at-risk requirement is inclusive; if an equity investment participates significantly in profits but not losses, or vice versa, then this requirement is not met.

Question 4.3.50#

When is an equity investment's participation in profits and losses significant?

Interpretive response: We believe an equity investment's participation in a legal entity's profits and losses generally is significant if the equity investment participates in the profits and losses on a pro rata basis based on the investor's ownership percentage in the entity.

For example, assume an investor owns 1% of a legal entity's outstanding common shares and participates in the entity's profits and losses on a pro rata basis. In this example, the investor's ownership interest is small relative to the outstanding equity. Nevertheless, the fact that the investor participates on a pro rata basis indicates that its equity investment participates significantly in the entity's profits and losses.

However, there may be additional facts and circumstances indicating that pro rata participation is not significant participation. An enterprise needs to evaluate:

— the nature of the legal entity's assets and operations;
— the magnitude of the potential profits and/or losses in relation to the initial equity investment; and
— the nature and terms of the equity instruments that make up the equity investment.

Below are some common features in equity instruments and examples of factors to consider when evaluating whether those features would prevent an equity instrument from participating significantly in the entity's profits and losses even when it appears to participate on a pro rata basis.

Equity instruments with put or redemption features

An equity instrument might not subject an investor to any of the legal entity's losses if the equity investor has the option to put (sell) the equity instrument back to the legal entity or to other investors at a fixed or predefined price. An enterprise must understand how the terms of the put or redemption feature would limit the investor's potential losses when evaluating whether the instrument participates significantly in the legal entity's profits and losses.

For example, Investor1 and Investor2 form Legal Entity in the following transaction.

There is uncertainty about the performance of the contributed assets at the inception of Legal Entity because they might appreciate or depreciate significantly due to changes in market conditions. Due to this uncertainty, Investor2 agrees to give Investor1 the right to put its equity interest to Investor2 at the interest’s initial fair value ($500). The option is inseparable from the equity interest and is issued as part of the design of Legal Entity. As a result of the put option, Investor1’s equity interest does not participate significantly in Legal Entity’s losses because Investor1 would have no obligation to absorb any losses.

See Question 4.3.140 for additional guidance on how to evaluate whether put options affect the investor's ability to participate significantly in profits and losses.

Call options on equity instruments

Equity instruments that may be called (purchased) by the entity or other equity investors might not participate significantly in the entity's profits depending on the extent to which the equity holder is limited from receiving profits.

Changing the above example, assume that Investor1 receives an option to purchase Investor2’s 50% equity interest at a future date for $510 and the option is inseparable from the equity interest. In this scenario, Investor2’s equity interest likely would not participate significantly in the entity's profits because, if profits did occur, Investor1 probably would purchase Investor2’s interest.

See Question 4.3.140 for additional guidance on how to evaluate whether call options affect the investor's ability to participate significantly in profits and losses.

Guaranteed returns

When an equity investor's returns are guaranteed by the legal entity or another party involved with the legal entity, the investor's equity investment is typically not considered to participate significantly in the legal entity's losses.

Question 4.3.60

Do equity instruments with fixed rates of return participate significantly in profits and losses?

Interpretive response: We believe there is a presumption that an equity instrument with a fixed rate of return does not participate significantly in the legal entity's profits and losses.

This presumption can be overcome. It is typically straightforward to demonstrate that a fixed-rate equity instrument, such as preferred stock, participates significantly in a legal entity's losses because the investor's subordinated capital investment is exposed. It is more challenging to demonstrate that such an instrument participates significantly in an entity's profits.

For a fixed-rate instrument to participate significantly in an entity's profits, we believe the fixed rate of return needs to provide an equity-like return for the legal entity. This means the fixed rate must approach the legal entity's expected return on equity. For example, preferred stock with a 12% annual dividend rate has an equity-like return if the legal entity is expected to yield a 15% annual return on equity. In contrast, preferred stock with a 4% annual dividend rate in the same legal entity does not have an equity-like return and therefore may not participate significantly in the entity's profits and losses.

Question 4.3.70

Is an interest in specified assets considered an equity investment at risk in the legal entity?

Background: An interest in specific assets of a legal entity is not a variable interest in the legal entity itself if the fair value of the assets comprises 50% or less of fair value of the legal entity's total assets (see section 3.6). Such an interest is referred to as an interest in specified assets. [810-10-25-55]

A potential silo is an economically segregated portion of a legal entity's net assets. A potential silo is treated as a separate entity (a silo VIE) under the VIE consolidation guidance only if its identified assets are essentially the only source of payment for its identified liabilities and other interests and the residual entity is a VIE (see section 3.7). [810-10-25-57 – 25-58]

Interpretive response: No. We do not believe an interest in specified assets (including a potential silo that is an interest in specified assets) can be an equity investment at risk in the legal entity itself because the variability associated with those assets is excluded from the legal entity when determining whether the residual entity is a VIE; see Question 3.6.40 on interests in specified assets and Question 3.7.60 on interests in potential silos.

This conclusion was confirmed by the staff in the SEC's Office of the Chief Accountant when it responded to this question from members of SIFMA, a trade association for broker-dealers, investment banks and asset managers.

If all of a legal entity's equity represents interests in specified assets, there is no equity at risk in the residual legal entity. In that case, we believe the legal entity does not have sufficient equity at risk. We believe that a VOE must have some equity at risk.

Nonregistered series investment funds and similar entities (e.g. segregated or protected cell companies) are typically VIEs for this reason. This assumes the individual investment funds in the series are not themselves considered to be separate legal entities (see Questions 2.3.70 and 2.3.80).

Question 4.3.80

How is the second at-risk requirement applied?

Interpretive response: The second requirement for an equity investment to be considered at risk is that it not be issued by the legal entity in exchange for subordinated interests in another VIE. Conclusions about whether equity has been issued in exchange for subordinated interests in another entity often will require judgment to understand how the individual transaction fits into a larger series of transactions.

This requirement prevents a single equity investment in one entity from capitalizing multiple entities. For example, assume that Investor uses $1,000 of cash to capitalize VIE1 at inception in exchange for an equity interest. After this transaction, Investor capitalizes VIE2 by contributing its equity interest in VIE1. In this example, the equity received by Investor in VIE2 is not considered an equity investment at risk because it was obtained in exchange for a subordinated interest (i.e. equity) issued by another VIE.

Question 4.3.90

How is the third at-risk requirement applied?

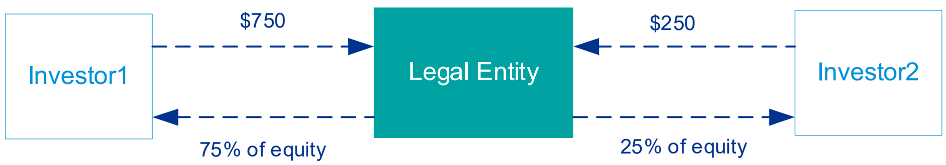
Interpretive response: Under the third at-risk requirement, an equity investment is not considered to be at risk if the cash or other consideration used to make the investment was funded directly or indirectly by fees, charitable contributions or other payments made to the investor by the legal entity or parties that are involved with the legal entity.

There is an exception when the provider of the funds is a parent, subsidiary or affiliate of the investor that is required to be included in the same consolidated financial statements as the investor. Therefore, the equity invested in a legal entity must represent the investor's real economic resources at risk. Equity investments provided by the legal entity or others involved with the legal entity are not considered at risk because the investors do not have economic downside. [810-10-15-14(a)(3)]

Example 4.3.10
Equity investment funded by legal entity

Background

Investor1 and Investor2 form Legal Entity through the following transaction.



— Legal Entity's profits and losses are allocated on a pro rata basis – i.e. 75% to Investor1 and 25% to Investor2.
— Investor2 receives an up-front administrative fee of $500 from Legal Entity.

Evaluation

Investor2's equity investment of $250 is funded entirely by the $500 up-front administrative fee from Legal Entity. Therefore, Investor2 does not have an equity at risk investment in Legal Entity.

Question 4.3.100
Do all fees paid by a legal entity to an investor reduce the amount of the investor's equity at risk?

Interpretive response: The guidance discussed in Question 4.3.90 appears to indicate that all fees paid by an entity to an equity investor reduce the amount of the investor's equity at risk. [810-10-15-14(a)(3)]

However, we believe an enterprise should evaluate the terms and substance of all fee and similar arrangements to understand whether these arrangements are intended to provide a return of capital to the equity investors. If a fee is designed to return capital to the equity investors, we believe that amounts received through the fee arrangement reduce the investor's equity investment at risk.

Below are some common arrangements that may or may not reduce an investor's equity investment at risk.

Fees paid over time in the future (at market value)

Fees to be paid for services rendered over a specified period in the future at the market rate at the time of payment typically do not reduce the investor's equity investment at risk. This is because the fee arrangement is not structured to return capital to the investor.

Fees paid over time in the future (above market value)

Fees to be paid for services rendered over a specified period in the future at a rate above the market rate at the time of payment typically reduce the investor's equity investment at risk. In this situation, the portion of the fee that represents the above-market component reduces the investor's equity investment at risk because it is designed as a mechanism to return capital. Further, such fees are considered a variable interest in the entity because the fees are not commensurate with the investor's efforts (see section 3.8).

Up-front and unconditional fees

We believe the following fees reduce the investor's equity investment at risk:

- up-front fees paid by the entity to the equity investor – e.g. concurrent with the formation of the legal entity;
- unconditional fees to be paid over time because they represent a return of capital.

If unconditional fees will be received in the future, the amount of the investor's equity investment at risk is reduced for the present value of those fees.

Reimbursements

If the equity investor receives cash or other assets from the legal entity to pay an unaffiliated third party for services it rendered to the entity, the investor's equity investment at risk is not reduced. In this case, the equity investor is essentially serving as a conduit through which payment is made.

Contingent fees

If the equity investor will receive fees only in certain contingent events, we believe those fees do not reduce the amount of its equity investment at risk if the contingencies are substantive – i.e. if there is a substantive risk that the contingent events will not occur. An enterprise should consider all relevant facts and circumstances when evaluating whether a contingent fee is substantive.

Sweat equity

Sweat equity is an equity investment that is received by an equity investor in exchange for performing services. We believe sweat equity interests are not equity investments at risk because the legal entity is providing those interests to the investor as fees.

Example 4.3.20
Various fees received by an equity investor

Background

Enterprise (a landowner and developer) and Investor form Legal Entity through the following transaction.

Legal Entity will construct a residential condominium. Enterprise's rights and responsibilities concerning Legal Entity include the following.

— At Legal Entity's inception, Enterprise is paid an up-front development fee of $10,000 and is guaranteed an additional $5,250 on the first anniversary of Legal Entity's formation.

— If Legal Entity generates a return of more than 20% over the next three years, Enterprise will receive an additional $15,000. Legal Entity expects to generate a return of approximately 8% over this time.

— Enterprise will be the property manager on completion of construction and receive a market-based fee of $20,000 each year.

Evaluation

Enterprise's equity investment at risk of $10,000 is computed as follows.

Equity contribution	$25,000
Less: Up-front development fee	(10,000)
Less: Present value guaranteed development fee1	(5,000)
Enterprise's equity investment at risk	$10,000

Note:
1. Present value computed using a 5% discount rate

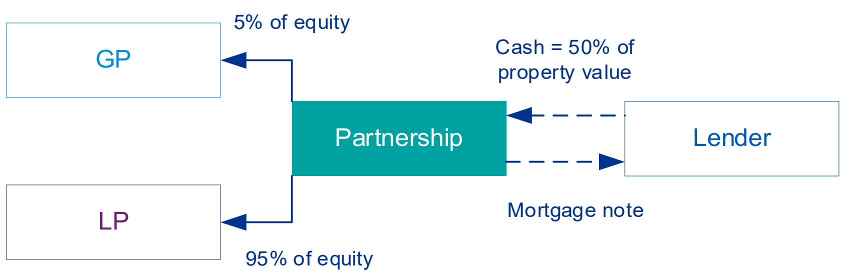
The $15,000 contingent fee does not reduce Enterprise's equity investment at risk because the contingency is substantive. The $20,000 management fee also does not reduce its equity investment at risk it represents a market-based fee for Enterprise's management services.

Example 4.3.30
Development fees received by LP

Background

An affordable housing limited partnership (Partnership) is formed to develop and operate a multifamily housing project. If a specified number of the housing units remain affordable for at least 15 years to tenants who earn 60% or less of the area median income, Partnership's investors are eligible for a 10-year federal income tax credit.

Partnership is formed and capitalized through the following transaction.



— Cash contributed by GP and LP is in proportion to their ownership percentages.

— GP also:

  – guarantees LP that the project will be developed as required to be eligible for the income tax credits;
  – receives a development fee at inception of the arrangement equal to 6% of the initial property value;
  – receives the majority of the benefit if the property is able to generate rental payments that exceed expectations; and
  – receives the residual value of the property.

— LP expects to receive its investment return entirely through the income tax credits, which is economically equivalent to the return received by an investor in investment grade debt.

— Other than the guarantee arrangement and GP's right to the residual value of the property, all expected Partnership losses are shared in proportion to their ownership percentages.

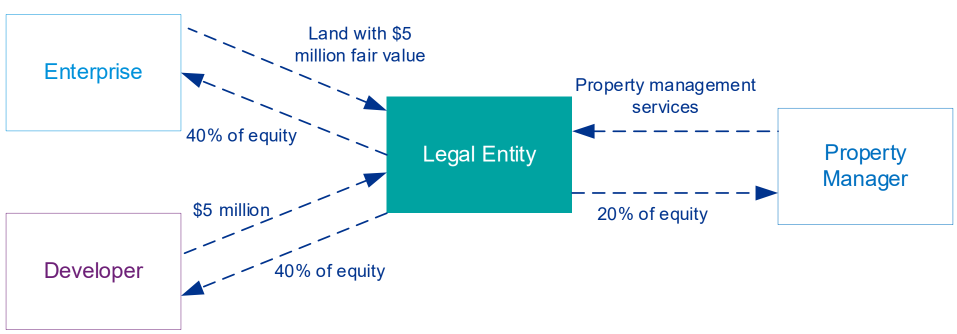
Evaluation

GP’s equity investment (5% of total partnership interests, which represents 2.5% of the total property value) is less than the amount of the up-front fee (6% of total property value) that GP receives. As a result, GP's equity investment is not considered at risk.

Example 4.3.40
Sweat equity

Background

Enterprise (a landowner) and Developer (an investor) form Legal Entity to develop and operate a commercial real estate property. They also provide an equity interest in Legal Entity to Property Manager in exchange for ongoing property management services.



At Legal Entity’s formation, each party's equity interests, and related fair values are as follows.

	Ownership %	Fair value
Enterprise	40%	$4,000,000
Developer	40%	$4,000,000
Property Manager	20%	$2,000,000

Evaluation

Legal Entity has $8 million of equity at risk (comprising the equity interests held by Enterprise and Developer). The $2 million equity investment held by Property Manager is not considered to be at risk because this interest was received in exchange for the performance of property management services (i.e. it represents sweat equity).

Question 4.3.110

Is equity exchanged for intangible assets equity at risk?

Interpretive response: It depends. Example 4.3.40 illustrates the transfer of tangible property to a legal entity (cash and land) in exchange for an equity interest in the entity. We believe that when there is an exchange of intangible assets for an equity interest, the resulting equity investment may also be considered at risk if the intangible assets are identifiable and therefore meet the requirements to be separately recognized as assets apart from goodwill under Topic 805 (business combinations).

We believe such an equity investment may be considered at risk even if the legal entity is a private company that has elected not to separately recognize those assets under the private company alternative (see paragraph 805-20-25-30).

Question 4.3.120

How is the fourth at-risk requirement applied?

Interpretive response: Under the fourth at-risk requirement, an equity investment is not considered to be at risk if the cash or other consideration used to make the investment was financed directly by the legal entity or other parties involved with the legal entity. There is an exception when the provider of the financing is a parent, subsidiary or affiliate of the investor that is required to be included in the same consolidated financial statements as the investor. Parties involved with the legal entity include, but are not limited to, parties that have either an explicit or implicit variable interest in the entity. [810-10-15-14(a)(4)]

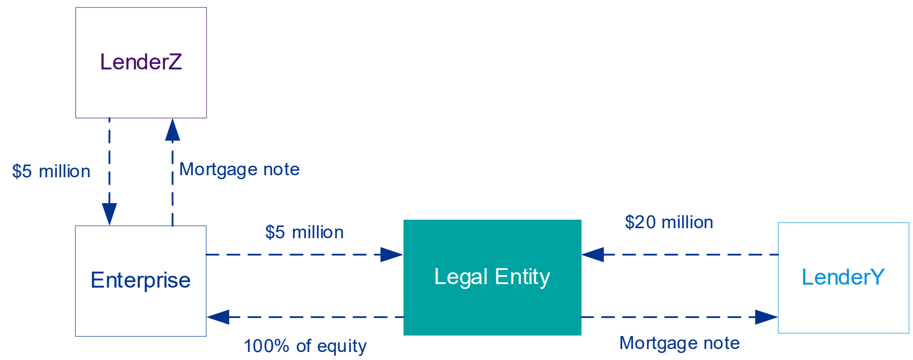
We believe the fourth at-risk requirement is very broad and includes loans, guarantees of loans and other instruments that embody an obligation of the legal entity (or parties involved with the legal entity), including those in the scope of Topic 480 (liabilities vs equity).

This requirement precludes only an equity investment that was financed by parties involved with the legal entity from being considered at risk. We believe it does not preclude an equity investment financed by parties not involved with the legal entity from being considered at risk.

Example 4.3.50
Effect of financing on equity at risk

Scenario 1: Financing provided by lender not involved with the legal entity

Enterprise (a landowner) forms Legal Entity through the following transaction to develop and operate a $25 million retail shopping center.



The mortgage note from Enterprise to LenderZ is recourse only to Enterprise's equity interest in Legal Entity and not to Enterprise's general credit.

Evaluation

LenderZ is not affiliated with Enterprise or Legal Entity. Therefore, the $5 million equity investment made by Enterprise is considered at risk because it was financed by a lender unaffiliated with Legal Entity.

Scenario 2: Financing provided by lender involved with the legal entity

Assume the same facts as Scenario 1, except that $2 million of Enterprise's $5 million equity investment is financed by LenderY and the remaining $3 million is financed by LenderZ.

Evaluation

In this scenario, Legal Entity has only $3 million of equity at risk because $2 million of the equity was financed by LenderY, which is involved with Legal Entity.

Question 4.3.130

How can arrangements occurring outside a legal entity affect whether an equity investment is at risk?

Interpretive response: When evaluating whether an investor's equity investment is at risk an enterprise assesses the effects of certain activities or arrangements that the legal entity is not a direct party to. Such activities and arrangements include financing arrangements, derivative positions and other activities occurring around the entity. The same type of evaluation is necessary when identifying holders of variable interests (see chapter 3).

The SEC staff has highlighted the need to consider activities occurring outside of a legal entity when applying the VIE guidance (see below). We believe the guidance in the following excerpt from that speech remains relevant even though the speech references the consolidation literature before the issuance of ASU 2009-17. [2004 AICPA Conf]

Excerpt from SEC staff speech

We have seen a number of questions about whether certain aspects of a relationship that a variable interest holder has with a variable interest entity (VIE) need to be considered when analyzing the application of FIN 46R [the VIE guidance in ASC Subtopic 810-10]. These aspects of a relationship are sometimes referred to as "activities around the entity". It might be helpful to consider a simple example. 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 FIN 46R [the VIE guidance in ASC Subtopic 810-10]. The short answer is no. First, FIN 46R [the VIE guidance in ASC Subtopic 810-10] specifically requires you to consider loans between investors as well as those between the entity and the enterprise in determining whether equity investments are at risk,[1] and whether the at risk holders possess the characteristics of a controlling financial interest as defined in FIN 46R [ASC paragraph 810-10-15-14(b)].[2] 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 "activities around the entity" that should be considered when applying FIN 46R [the VIE guidance in ASC Subtopic 810-10] include equity investments between investors, puts and calls between the enterprise and other investors and non-investors, service arrangements with investors and non-investors, and derivatives such as total return swaps. There may be other activities around the entity that need to be considered which I have not specifically mentioned. These activities can impact the entire analysis under FIN 46R [the VIE guidance in ASC Subtopic 810-10] including the assessment of whether an entity is a VIE as well as who is the primary beneficiary.

In another situation involving activities around the entity, investors became involved with an entity because of the availability of tax credits generated from the entity's business. Through an arrangement around the entity, the majority of the tax credits were likely to be available to one specific investor. Accordingly, the staff objected to an analysis by this investor that 1) did not include the tax credits as a component of the investor's variable interest in the entity and 2) did not consider the impact of the tax credits and other activities around the entity on the expected loss and expected residual return analysis.

1 FIN 46R, paragraph 5(a)(4) [ASC subparagraph 810-10-15-14(a)(4)].
2 FIN 46R, paragraph 5(b) [ASC subparagraph 810-10-15-14(b)].

Jane D. Poulin, Remarks before the 2004 AICPA National Conference on Current SEC and PCAOB Developments

Question 4.3.140

How do call options, put options and TRS affect the at-risk requirements?

Interpretive response: An investor's equity interest in a legal entity may be subject to a call option, put option or TRS. Depending on the terms and the counterparty's involvement with the legal entity (see Question 4.3.130), these derivatives may reduce the amount of the investor's equity at risk.

The following table outlines different scenarios for call options, put options and TRS as well as whether we believe the arrangement would cause the at-risk requirements not to be met (specifically, the first and fourth at-risk requirements). Regardless of the scenario, a key consideration when analyzing the at-risk requirements is the design of the entity. Significant judgment may be required when assessing the impact of an arrangement on the at-risk requirements, and it is important to consider the way in which the legal entity was structured. Considering the design of the legal entity provides important context to this analysis. [810-10-15-14]

Derivative	Counterparty	1st at-risk requirement met?	4th at-risk requirement met?
Fixed-price, physically settled call option written by the equity investor on its equity interest	Unrelated party that has no involvement with the legal entity	Yes. The characteristics of the equity instrument are unaffected by the call option. Even though the call option may limit the equity investor's	Yes. The counterparty is an unrelated party that has no involvement with the legal entity.

Derivative	Counterparty	1st at-risk requirement met?	4th at-risk requirement met?
		participation in the legal entity's profits, that limitation does not arise because of the terms of the equity instrument.	
Fixed-price, physically settled put option purchased by the equity investor on its equity interest	Unrelated party that has no involvement with the legal entity	Yes. Similar to the written call option, the characteristics of the equity instrument are unaffected by the put option. Even though the put option may limit the equity investor's participation in the legal entity's losses, that limitation does not arise because of the terms of the equity instrument.	Yes. The counterparty is an unrelated party that has no involvement with the legal entity.
Net settleable TRS entered into by the equity investor based on the total return of its equity investment	Unrelated party that has no involvement with the legal entity	Yes. Even though the TRS may limit the equity investor's participation in the legal entity's profits and losses, that limitation does not arise because of the terms of the equity instrument.	Yes. The counterparty is an unrelated party that has no involvement with the legal entity.
Fixed-price, physically settled call option written by the equity investor on its equity interest	The legal entity	No. Because the option is entered into with the issuer of the equity and the equity is the underlying, we believe the option is inseparable from the equity instrument. Because the option limits the equity investor from participating in the	Yes, unless the call option is deep in the money when it is written. If the call option is deep in the money, we believe the premium received by the equity investor is a form of financing received from the legal entity and this requirement is not met.

Derivative	Counterparty	1st at-risk requirement met?	4th at-risk requirement met?
		legal entity's profits, this requirement is not met.	If the call option is not deep in the money when it is written, this requirement is met; this is because the equity interest was not financed by the legal entity
Fixed-price, physically settled put option purchased by the equity investor on its equity interest	The legal entity	No. Because the option is entered into with the issuer of the equity and the equity is the underlying, we believe the option is inseparable from the equity instrument. Because the option protects the equity investor from participating in the legal entity's losses, this requirement is not met	No. We believe an investor with the ability to exercise a fixed-price put option (which guarantees the return of some, or all, of its equity investment) economically participates in the legal entity's operations in the same way it would if it had financed the equity investment with the legal entity at inception.
Fixed-price, physically settled call option written by the equity investor on its equity interest	A party involved with the legal entity	Generally, yes. The characteristics of the equity instrument are unaffected by the call option. Even though the call option may limit the equity investor's participation in the legal entity's profits, that limitation does not arise because of the terms of the equity instrument. However, if the call option is inseparable from the equity instrument, we	Yes, unless the call option is deep in the money when it is written. If the call option is deep in the money, we believe the premium received by the equity investor is a form of financing received from the party that is involved with the legal entity and this requirement is not met. If the call option is not deep in the money when it is written, this requirement is met because the equity

Derivative	Counterparty	1st at-risk requirement met?	4th at-risk requirement met?
		believe it limits the equity investor from participating in the legal entity's profits and therefore this requirement is not met. For example, this requirement is not met if the terms of Investment A allow the holder of Investment B to buy Investment A for a fixed price.	interest was not financed by the party involved with the legal entity.
Fixed-price, physically settled put option purchased by the equity investor on its equity interest	A party involved with the legal entity	Generally, yes. Similar to the written call option, the characteristics of the equity instrument are unaffected by the put option. Even though the put option may limit the equity investor's participation in the legal entity's losses, that limitation does not arise because of the terms of the equity instrument. However, if the put option is inseparable from the equity instrument, we believe it protects the equity investor from participating in the legal entity's losses and therefore this requirement is not met. For example, this requirement is not met if the terms of Investment A allow its holder to sell its	No. We believe an investor with the ability to exercise a fixed-price put option (which guarantees the return of some, or all, of its equity investment) economically participates in the legal entity's operations in the same way it would if it had financed the equity investment with the other party at inception.

Derivative	Counterparty	1st at-risk requirement met?	4th at-risk requirement met?
		interest to the holder of Investment B for a fixed price.	
Net settleable TRS entered into by the equity investor based on the total return of its equity investment	A party involved with the legal entity	Generally, yes. Even though the TRS may limit the equity investor's participation in the legal entity's profits and losses, that limitation does not arise because of the terms of the equity instrument. However, if the TRS is inseparable from the equity instrument, we believe it limits the equity investor from participating in the legal entity's profits and losses and therefore this requirement is not met.	No. We believe an investor with a TRS economically participates in the legal entity's operations in the same way it would if it had financed the equity investment with the other party at inception.

4.3.40 Step 3: Determining sufficiency of equity investment at risk

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

>> Sufficiency of Equity Investment at Risk

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.

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.

25-47 The design of the legal entity (for example, its capital structure) and the apparent intentions of the parties that created the legal entity are important qualitative considerations, as are ratings of its outstanding debt (if any), the interest rates, and other terms of its financing arrangements. Often, no single factor will be conclusive and the determination will be based on the preponderance of evidence. For example, if a legal entity does not have a limited life and tightly constrained activities, if there are no unusual arrangements that appear designed to provide subordinated financial support, if its equity interests do not appear designed to require other subordinated financial support, and if the entity has been able to obtain commercial financing arrangements on customary terms, the equity would be expected to be sufficient. In contrast, if a legal entity has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that obviously is effectively a replacement for an additional equity investment, the equity would not be expected to be sufficient.

Once an enterprise identifies each equity investment at risk in a legal entity, it combines the equity investments at risk and determines whether the total equity at risk is sufficient in relation to the economic risks inherent in the legal entity’s activities. The legal entity’s activities comprise the entity’s operations and its assets and operating liabilities – regardless of whether those assets and liabilities are recognized under US GAAP. The legal entity is a VIE if the equity at risk is not sufficient to finance the entity’s activities without additional subordinated financial support. [810-10-15-14(a)]

Subtopic 810-10 identifies three approaches an enterprise can use to demonstrate that equity at risk is deemed sufficient to absorb a legal entity's expected losses. The first two approaches involve qualitative assessments and the third approach requires a quantitative assessment. [810-10-25-45]

First qualitative approach	The enterprise can demonstrate that the legal entity can finance its activities without additional subordinated financial support.
Second qualitative approach	The enterprise can demonstrate that 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.
Quantitative approach	The enterprise can demonstrate that the amount of the legal entity's equity at risk exceeds the estimate of the legal entity's expected losses based on reasonable quantitative evidence.

Question 4.3.150

Is one approach for determining the sufficiency of equity at risk better than the others?

Interpretive response: The two qualitative approaches described in Question 4.3.140 are often conclusive for determining the sufficiency of equity at risk. This means the quantitative approach generally should be performed only if the qualitative analyses provide inconclusive results. [810-10-25-45, FIN 46(R).9]

The FASB acknowledged that applying qualitative considerations may be difficult. For example, it may be a challenge to find comparably sized entities that have similar assets, liabilities and other interests that have financed their operations without additional subordinated financial support. As a result, the guidance permits a quantitative comparison of a legal entity's equity at risk with its expected losses.

Expected losses are not the anticipated amount or variability of the net income or loss. Instead, they are the expected negative variability in the fair value of the legal entity's net assets (excluding variable interests). See chapter 10 for additional guidance on how to compute expected losses.

A quantitative approach to determine the sufficiency of an entity's equity at risk may seem more precise and less subjective than a qualitative analysis. However, the subjective estimates and assumptions necessary to apply a quantitative approach results in imprecision. For this reason, the FASB indicated that reasoned professional judgment that is based on all the relevant facts and circumstances is often as good as, or even better than, mathematical computations based on estimates and assumptions. [FAS 167.BC.A43]

Question 4.3.160

Can an enterprise rely solely on the quantitative approach to demonstrate sufficiency of equity at risk?

Interpretive response: It depends. Paragraph 810-10-25-45 states that an enterprise could perform a "...a qualitative analysis or quantitative analysis or a combination of both" to demonstrate that equity is sufficient. However, it also states that a quantitative assessment should only be performed if "a reasonable conclusion about the sufficiency of the legal entity's equity at risk cannot be reached based solely on qualitative considerations." As a result, we believe an enterprise that initially uses the quantitative approach and concludes that equity at risk **is not** sufficient must also consider the two qualitative approaches. [810-10-25-45]

If an enterprise initially uses the quantitative approach and concludes that equity at risk is sufficient, it may still need to consider qualitative factors. The extent of the enterprise's qualitative analysis likely will vary based on the subjectivity and sensitivity of the assumptions it used in its quantitative analysis.

For example, assume that Enterprise forms Legal Entity by contributing $5,000 of cash in exchange for 100% of Legal Entity's equity, all of which is considered at risk. Enterprise performs a quantitative analysis to compare the amount of equity at risk to an estimate of Legal Entity's expected losses. Although Legal Entity's equity at risk ($5,000) exceeds the expected losses ($4,950), slightly changing some of the estimates or assumptions in the quantitative analysis could alter the overall result. In this example, Enterprise should perform a qualitative analysis to ascertain whether Legal Entity's equity at risk is sufficient.

Question 4.3.170

What qualitative factors does an enterprise consider when determining whether equity at risk is sufficient?

Interpretive response: Qualitative factors that an enterprise considers when evaluating the sufficiency of a legal entity's equity at risk include the following (not exhaustive): [810-10-25-47]

- design of the legal entity, including its capital structure – e.g. terms, ratings, maturities, and amounts of its instruments;
- nature of its operations – e.g. source of cash flows, key products and services provided, areas of operation;
- nature of its assets – e.g. credit quality, asset types, liquidity; and
- apparent intentions of the parties that created the legal entity.

Objectively demonstrating that a legal entity can finance its activities may be difficult if the entity has a complex capital structure. For example, a legal entity capitalized with multiple classes of debt that have different priorities may be unable to demonstrate the ability to finance its activities without additional financial support; this is because it could be ambiguous whether the equity at risk alone is sufficient to absorb the entity's expected losses.

Question 4.3.180
How is the quantitative approach performed to determine whether equity at risk is sufficient?

Interpretive response: When applying the quantitative approach, we believe an enterprise should compare the fair value of the legal entity's equity at risk to the entity's expected losses.

The enterprise should use the guidance in Topic 820 (fair value measurement) to compute the fair value of the legal entity’s equity at risk. The fair value of the legal entity’s equity at risk may equal its carrying amount on the date of the legal entity’s inception. However, those measurements typically will differ on later dates. Using fair value (instead of than the US GAAP carrying amount) of the equity at risk is consistent with how the enterprise computes expected losses (see chapter 10).

Expected losses are the expected negative variability in the fair value of the legal entity’s net assets (excluding variable interests). When computing a legal entity’s expected losses (and residual returns), an enterprise must consider all possible scenarios and weigh those scenarios based on their probability (see chapter 10).

Example 4.3.60
Equity at risk compared with expected losses

Background

Investor1 and Investor2 form Legal Entity through the following transaction to conduct R&D activities.

— Both equity contributions meet the at-risk requirements.

— Legal Entity applies the guidance in the Acquisition of Assets Subsections of Subtopic 805-50. Using that guidance, it immediately expenses the in-process R&D (i.e. no asset is recognized); see Question 4.2.20 in KPMG Handbook, Asset acquisitions.

— At its inception, Legal Entity has no debt and has expected losses of $3,000.

Evaluation

The fair value of Legal Entity's equity at risk is $5,000 (which includes the equity received in exchange for both cash and IPR&D), even though equity as reported in the US GAAP financial statements is only $2,500 (the carrying amount of the only recognized asset – cash). Because the fair value of the equity at risk exceeds the expected losses of $3,000, the equity at risk is sufficient to absorb expected losses. Therefore, Legal Entity does not possess the first VIE characteristic.

Question 4.3.190

Is equity at risk sufficient when it is 100% of a legal entity's total assets?

Interpretive response: Yes. We believe equity at risk is always sufficient to absorb a legal entity's expected losses when it is equal to the legal entity's total assets because equity at risk can never be greater than 100% of the assets of an entity.

The plans of an entity may require additional equity or debt in the future as the entity buys additional assets and expands its operations. This fact does not result in the equity at risk being insufficient at formation because the equity at risk is sufficient to absorb expected losses based on the entity's current operations.

However, if the legal entity does acquire additional assets or expand operations, its variable interest holders will need to reconsider its VIE status (see section 4.8). At that time, the redesign of the legal entity, its capital structure and any newly identified sources of variability that the entity is designed to create and distribute to its variable interest holders, are important qualitative considerations. For example, if the legal entity must issue subordinated debt to expand operations, it may no longer have sufficient equity at risk. No single factor is conclusive; careful consideration of all relevant facts and circumstances is necessary to conclude on sufficiency of equity at risk. [810-10-25-47]

Question 4.3.200

Are amounts reported in AOCI considered when applying the quantitative approach?

Interpretive response: When applying the quantitative approach, we believe an enterprise should compare the fair value of the legal entity's equity at risk to the entity's expected losses (see Question 4.3.180).

When an enterprise computes the fair value of a legal entity's equity at risk, it should include all equity components that are at risk, including AOCI.

If an enterprise is determining the fair value of equity at risk using an income approach (based on the legal entity's at-risk net assets), it should exercise caution not to double count the income attributable to instruments whose activity may be initially recognized in OCI and later reclassified into net income.

Question 4.3.210

Should expected losses from specified assets be considered in the quantitative approach?

Background: An interest in specific assets of a legal entity is not a variable interest in the legal entity itself if the fair value of the assets comprises 50% or less of fair value of the legal entity's total assets (see section 3.6). Such an interest is referred to as an 'interest in specified assets'. [810-10-25-55]

Interpretive response: No. As discussed in Question 4.3.70, an enterprise should remove the expected losses from specified assets from the legal entity's total expected losses when evaluating the sufficiency of the equity at risk. [810-10-25-56, 25-57]

Question 4.3.220

Is 10% equity at risk a safe harbor?

Interpretive response: No. 10% equity at risk is not a safe harbor. There is a rebuttable presumption that a legal entity's equity at risk must be at least 10% of its total assets to support a conclusion that the equity at risk is sufficient to finance the legal entity's activities without subordinated financial support. However, there is no inverse presumption that equity at risk of 10% or greater is sufficient. Therefore, the 10% presumption has little effect on evaluating whether a legal entity's equity at risk is sufficient. [810-10-25-45 – 25-46]

Question 4.3.230

What is the effect on equity at risk when investors in the equity-at-risk group also hold non-equity interests?

Interpretive response: Subparagraph 810-10-15-14(a) states that an entity's equity at risk is "required to be reported as equity in that entity's financial statements." Therefore, we believe other interests that are not equity under US GAAP should be not be considered when evaluating the sufficiency of a legal entity's equity at risk.

For example, assume that Legal Entity is capitalized with $100,000 of equity at risk and $40,000 of subordinated debt and both interests are held by Investor. If Legal Entity's expected losses are less than $100,000, the equity at risk is sufficient to permit Legal Entity to operate without additional subordinated financial support from other parties absent evidence to the contrary after considering qualitative factors.

However, if Legal Entity's expected losses are between $100,000 and $140,000, the equity at risk is not sufficient. This is the result even though Investor (a member of the equity-at-risk group) absorbs expected losses in excess of $100,000 through its subordinated debt interest.

Question 4.3.240

How does a subordinated debt issuance by a legal entity affect the sufficiency of the equity at risk?

Interpretive response: Subordinated debt represents additional subordinated financial support. Therefore, the legal entity cannot demonstrate that it can finance its activities without such support using the first qualitative approach. [810-10-25-45(a)]

However, the issuance of subordinated debt does not mean that the legal entity's equity at risk is insufficient to finance the entity's activities if the entity can demonstrate that:

— it has at least as much equity at risk invested as other similar entities (the second qualitative approach); or

— its equity at risk exceeds the estimate of its expected losses based on quantitative evidence (the quantitative approach), absent evidence to the contrary after considering qualitative factors.

The yield on the subordinated debt and the nature and quality of the legal entity's assets are some factors to consider in evaluating whether subordinated debt indicates that the entity's equity at risk is insufficient to finance its activities. Equity-like yields on the subordinated debt suggest that the legal entity does not have at least as much equity at risk as other similarly situated entities that operate with no additional subordinated financial support. Higher risk assets typically experience higher variability (and therefore more expected losses), which would require more equity at risk.

Example 4.3.70

Evaluating the sufficiency of equity at risk

Scenario 1: Unsecured loan guaranteed by equity investors

Legal Entity, a small-scale waste management company, provides garbage removal services for restaurants and commercial office properties in the Northeast.

At its inception, Legal Entity's balance sheet comprises the following.

Total assets	$ 15 million
Nonrecourse loan	$ 9 million

Unsecured loan	$ 2 million
Other operating liabilities	$ 2 million
Equity	$ 2 million

The following additional facts are relevant.

- The nonrecourse loan has a 5% coupon rate, a seven-year term and is secured only by garbage trucks and dumpsters – i.e. the lender has no recourse to the equity investors or other assets of Legal Entity.
- The unsecured loan pays a 9% annual coupon, has a nine-year term, and is guaranteed by the individual equity investors.
- All of the equity is considered at risk.

Evaluation

Legal Entity cannot finance its activities without additional subordinated financial support (the first qualitative approach) because the unsecured loan has recourse to the individual equity investors. The guarantee represents subordinated financial support.

Legal Entity's variable interest holders also need to apply the second qualitative approach to determine if Legal Entity has at least as much equity invested as other similar entities. If Legal Entity's equity at risk is not sufficient under the second qualitative approach, the variable interest holders need to perform the quantitative expected loss calculation to determine whether the equity at risk is sufficient to absorb Legal Entity's expected losses.

Although the at-risk equity to total assets ratio (13%) exceeds the 10% threshold, this factor is not determinative and therefore does not eliminate the need to compare Legal Entity's equity at risk to its expected losses.

Scenario 2: Unsecured loan not guaranteed by equity investors

Assume the same facts as Scenario 1, except that the unsecured loan is not guaranteed by the equity investors, has a 12% annual coupon and 15-year term, and the holder is entitled to 25% of net operating income above a pre-defined amount.

Evaluation

In this scenario, the variable interest holders must perform the quantitative expected loss calculation.

The high coupon on the unsecured debt appears to provide an equity-like return to the lender, suggesting that the equity at risk may be insufficient. The 12% annual interest rate and other equity participation features were required to compensate the lender for the lack of a guarantee by the equity investors. This fact indicates that Legal Entity' equity at risk may not be sufficient to absorb the expected losses.

Scenario 3: Some expected loss scenarios exceed equity at risk

Assume that the expected loss calculation in Scenario 2 indicates that Legal Entity’s expected losses are $1.5 million, but that certain expected loss scenarios exceed the $2 million of equity at risk.

Evaluation

Because Legal Entity’s equity at risk is greater than the expected losses, it is deemed sufficient under the quantitative approach even though a loss in excess of the equity at risk may be incurred in certain scenarios see Question 4.3.180.

The expected loss analysis requires an evaluation of whether the equity at risk exceeds the expected losses of Legal Entity as a whole instead of whether it is possible that losses in excess of the equity at risk could occur. Therefore, one loss scenario does not override the results of Legal Entity's expected loss computation that considers all possible scenarios on a probability-weighted basis.

Scenario 4: Loans from equity investors

Assume the same facts as in Scenario 1, except that the unsecured debt is not guaranteed by the equity investors and Legal Entity’s balance sheet at the date of Legal Entity’s inception comprises the following.

Total assets	$15.0 million
Nonrecourse loan	$ 7.0 million
Loans from equity investors	$ 4.0 million
Other operating liabilities	$ 2.5 million
Equity	$ 1.5 million

The following additional facts are relevant.

— The $7 million nonrecourse loan has an annual interest rate of 5%, is due in four years, and is secured only by Legal Entity’s garbage trucks and dumpsters – i.e. the lender has no recourse to the equity investors or other assets of Legal Entity.

— The loans made by the equity investors have an annual interest rate of 20% and a 15-year term. Legal Entity’s expected losses are $2 million.

— The variable interest holders are unable to conclude that Legal Entity’s equity at risk is sufficient under the qualitative approaches.

Evaluation

The loans from the equity investors are not considered equity at risk (even though their returns are equity-like) because they are reported as liabilities under US GAAP. Therefore, Legal Entity meets the first VIE characteristic – i.e. insufficient equity at risk – because its expected losses of $2 million exceed the $1.5 million of equity at risk.

Question 4.3.250

Does a bank or regulated financial institution have sufficient equity at risk if its capital exceeds the regulatory minimum?

Interpretive response: Not necessarily. We do not believe a bank or regulated financial institution's compliance with minimum regulatory capital levels demonstrates, in and of itself, that the bank or institution has sufficient equity at risk. However, this fact should be considered in the qualitative analysis.

For example, certain regulated financial institutions may operate at regulatory capital levels below 10% of their assets. We understand that such institutions are one of the reasons the FASB did not mandate that equity exceed 10% of assets in all situations to conclude that the equity at risk is sufficient.

Question 4.3.260

How is sufficiency of equity at risk determined in structures involving multiple legal entities or levels?

Interpretive response: We believe the assessment of whether equity at risk is sufficient should generally be performed for each legal entity on a stand-alone basis. However, it is important to understand the purpose, design and related risks of the structure in totality. Only substantive terms, transactions and arrangements are considered when applying the VIE guidance. [810-10-15-13A – 15-13B]

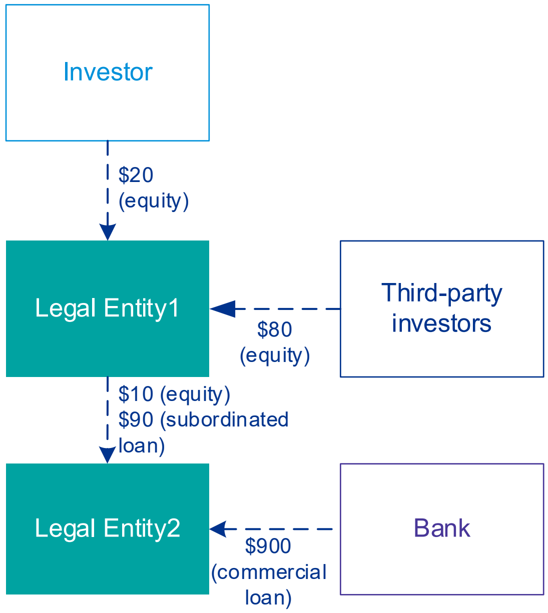
Example 4.3.80

Structure involving multiple legal entities

Background

Investor creates Legal Entity1 to raise funding and invest in a project developed by Legal Entity2.

Legal Entity1 and Legal Entity2 are initially capitalized as follows.



Legal Entity2 does not have sufficient equity at risk and is therefore a VIE. Legal Entity1 is the primary beneficiary of and consolidates Legal Entity2 because it has (see chapter 6):

- the power to direct the activities that most significantly impact Legal Entity2's economic performance; and
- an other-than-insignificant variable interest through its equity investment and subordinated loan.

Evaluation

To determine whether Legal Entity1 is a VIE, Investor first evaluates whether Legal Entity1's equity at risk is sufficient. We believe Investor should evaluate the sufficiency of Legal Entity1's equity at risk based only on whether Legal Entity1's $100 of equity is sufficient to finance its operations. Therefore, the fact that Legal Entity2, which Legal Entity1 consolidates, is capitalized largely by debt is not relevant to this evaluation.

Legal Entity1's equity at risk is sufficient to finance its operations because its equity at risk is equal to 100% of its assets (see Question 4.3.190).

Question 4.3.270

How is the sufficiency of equity at risk evaluated for a legal entity in the start-up phase?

Interpretive response: An enterprise should evaluate a legal entity in the start-up phase like any other legal entity when evaluating whether it is a VIE. It does not matter if the legal entity has not commenced planned principal operations or does not have significant revenue from its principal operations. [810-10-25-45 – 25-47]

The enterprise should evaluate the sufficiency of a legal entity's equity at risk based on the fair value of the legal entity's existing assets and the net income or loss expected to be generated from those assets.

The fair value of the existing assets and activities of a legal entity that expects to carry out its operations in phases may be affected by the likelihood and feasibility of completing the current phase.

— When it is remote that the current phase of the legal entity's activities will be successfully completed, we believe an enterprise should compute expected losses based only on the variability projected for that phase.

— When it is probable that the legal entity will progress beyond the current phase, we believe an enterprise should compute expected losses based on the variability projected for the current and probable future phases.

— When progress beyond the current phase is more than remote and less than probable, we believe an enterprise generally should compute expected losses based on the variability projected for current and probable future phases. However, when computing that variability, we believe the enterprise should adjust the probabilities associated with cash flow outcomes to reflect the uncertainty.

Subsequent reconsideration of expected losses

An enterprise must reconsider whether a legal entity is a VIE (including whether its equity at risk is sufficient) when the entity undertakes additional activities or acquires additional assets that: [810-10-35-4(c)]

— were not contemplated at the later of the entity's inception, or its latest reconsideration event; and
— increase the legal entity's expected losses.

Therefore, if the enterprise computed the legal entity's expected losses based only on the entity's current phase, it will need to reconsider the sufficiency of the equity at risk if and when the legal entity reaches future phases. An enterprise does not reconsider a legal entity's equity at risk (or its VIE status) because of operating losses. [810-10-15-14]

See also Question 6.3.160 for guidance on how to evaluate the power criterion when a VIE's activities are carried out in phases.

Example 4.3.90
Start-up legal entity

Background

Legal Entity, start-up company, is initially capitalized with voting common stock of $1 million and nonvoting preferred stock of $1 million. The preferred stock receives a cumulative preferred dividend of 15% before any return to the common stockholders. Legal Entity expects to generate an overall return of 16% and its initial equity is sufficient to support its operations during the start-up phase.

After five years of operations, a series of unexpected events that significantly affected Legal Entity’s business environment have eliminated Legal Entity's ability to continue operations based on its existing equity. However, management believes Legal Entity’s prospects are bright and develops a plan to expand operations. To implement this plan, it enters into negotiations with Venture Capital (VC) Fund to raise the necessary capital to continue existing operations and expand operations in the near future.

Legal Entity issues to VC Fund:

— senior debt of $60 million, bearing an interest rate of 8%; and
— subordinated debt of $38 million, bearing an interest rate of 14%.

With its subordinated debt investment, VC Fund obtains the right to nominate three out of seven members of Legal Entity's board of directors. As long as the subordinated debt remains outstanding, approval of the board members nominated by VC Fund is required for major decisions, such as the sale of certain assets or the execution of certain purchase or sales contracts.

Evaluation

Legal Entity is not a VIE at its inception under the quantitative approach because it has equity at risk equal to 100% of its assets (see Question 4.3.190).

The fact that Legal Entity incurs losses in excess of its expectations at inception does not cause it to subsequently become a VIE because those losses do not change the design of the entity.

However, the entity’s design does change five years after inception, when the equity owners give participating decision-making rights to a debt holder. As a result of this restructuring, the equity at risk is no longer sufficient. In addition, the restructuring provides substantive participating rights to the VC fund, allowing the VC fund the ability to participate in the activities that most significantly impact Legal Entity’s economic performance. Such a design change makes Legal Entity a VIE at that time (see section 4.4).

4.4 Second VIE characteristic: Lack of power to direct activities

4.4.10 General principles

Excerpt from ASC 810-10

Variable Interest Entities

> Entities

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase *by design* refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.)

a. …
b. As a group the holders of the equity investment at risk lack any one of the following three characteristics:
   1. The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance.
      i. For legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no **owners** hold voting rights or similar rights (such as those of a common shareholder in a corporation). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights (participating rights) as discussed in paragraphs 810-10-25-2 through 25-14 are not VIEs if the holders of the equity investment at risk as a group have the power to control the entity and the equity investment meets the other requirements of the Variable Interest Entities Subsections.
         01. If no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly impact the entity's economic performance, **kick-out rights** or **participating rights** (according to their VIE definitions) held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights shall not prevent the equity holders from having this characteristic unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A **decision maker** also shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 810-10-55-37 through 55-38.
      ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists. The guidance in this subparagraph does not apply to entities in industries (see paragraphs 910-810-45-1 and 932-810-45-1) in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).
         01. A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive **kick-out rights** (according to their voting interest entity definition) through voting interests over the general partner(s).

> A. For purposes of evaluating the threshold in (01) above, a general partner's kick-out rights held through voting interests shall not be included. Kick-out rights through voting interests held by entities under common control with the general partner or other parties acting on behalf of the general partner also shall not be included.
>
> 02. Limited partners with equity at risk are able to exercise substantive **participating rights** (according to their voting interest entity definition) over the general partner(s).
> 03. For purposes of (01) and (02) above, evaluation of the substantiveness of participating rights and kick-out rights shall be based on the guidance included in paragraphs 810-10-25-2 through 25-14C.

The second characteristic of a VIE is that the equity-at-risk group lacks the power to direct the activities that most significantly impact the legal entity's economic performance. If the equity-at-risk group does not have the power to direct the legal entity's most significant activities, the legal entity is a VIE. Without such power, the equity at risk does not have the characteristics necessary to rely solely on voting control as the basis for consolidation. [810-10-15-14(b)(1)]

The analysis of whether a legal entity's equity-at-risk group has the power to direct the legal entity's most significant activities differs for limited partnerships (and similar entities) versus corporations. Consequently, in some situations (e.g. when the legal entity is a limited liability company), an enterprise will need to determine whether a legal entity is more similar to a limited partnership or a corporation.

This section describes general principles that apply to the second VIE characteristic. Section 4.4.20 describes how to apply the characteristic to entities other than limited partnerships, and section 4.4.30 describes how to apply the characteristic to limited partnerships.

Determining whether legal entity is a limited partnership or similar entity

Question 4.4.10

How does an enterprise evaluate whether a legal entity is similar to a limited partnership?

Interpretive response: A legal entity is similar to a limited partnership when it has 'governing provisions that are the functional equivalent of a limited partnership.' [810-10-05-3]

A legal entity with governing provisions that are the functional equivalent of a limited partnership generally has a single investor that is responsible for managing the entity's operations. The delegation of operational authority to the managing investor is part of the agreement among all of the investors. The managing investor would meet the definition of a 'decision-maker' (see section

3.8) absent consideration of any kick-out rights or participating rights held by the other investors.

A key feature that distinguishes entities that are similar to limited partnerships from other entities with an outsourced manager is the nature of the decision-making authority. The manager's decision-making authority in an entity that is similar to a limited partnership is conveyed through an interest that represents equity under US GAAP (see Question 4.4.20)

Conversely, the decision-making authority of an outsourced manager in an entity that is not similar to a limited partnership is not conveyed through the manager's US GAAP equity interest (if any). That is, in an entity that is not similar to a limited partnership, an outsourced manager need not hold an equity interest to obtain and maintain its contractual decision-making authority.

Another factor to consider is whether the legal entity maintains separate capital accounts. Under Topic 323 (equity method), when a legal entity maintains separate capital accounts, the investor must evaluate significant influence as if the legal entity were a limited partnership. [323-30-35-3]

Question 4.4.20

When is a decision-maker's authority conveyed through an equity interest?

Background: It is common for enterprises that offer investment management services (asset managers) to have equity in the legal entities they manage. Sometimes the equity is held directly by the enterprise that provides the investment management services. Other times, an affiliate of the enterprise that provides the investment management services holds the equity.

Interpretive response: We believe a decision-maker's authority generally is deemed to be conveyed through the equity-at-risk investment if the decision-maker or its affiliates must hold the investment to retain the authority to make significant decisions. In that situation, the legal entity has governing provisions that are the functional equivalent of a limited partnership and an enterprise should apply the principles for limited partnerships and similar entities when determining whether the equity-at-risk investors have power (see Question 4.4.200).

In contrast, if the decision-maker could retain the authority to make significant decisions even if it (or its affiliates) disposes of its equity-at-risk investment, we believe the decision-maker obtains its authority through a non-equity-at-risk interest. In that situation, the legal entity may not have governing provisions that are the functional equivalent of a limited partnership and more analysis is required. If an enterprise concludes that the legal entity is not similar to a limited partnership, it applies the principles applied to entities other than limited partnerships when determining whether the equity-at-risk investors have power (see Question 4.4.80).

The legal entity's governing documents may not state whether the decision-maker or its affiliates are required to hold an equity interest in the entity to obtain or retain its decision-making authority. In that case, we believe an enterprise should presume the decision-maker has obtained its power though a non-equity-at-risk interest. However, the enterprise should consider whether there are other facts and circumstances that demonstrate that the decision-maker's power is conveyed through an equity investment.

Example 4.4.10
Decision-maker receives fees for services

Scenario 1: Asset Manager receives a base fee and a performance fee for managing Investment Entity

The asset management contract requires Asset Manager to make an initial equity investment in Investment Entity and maintain an equity interest of no less than 1% for as long as it is the asset manager.

Asset Manager's authority is deemed to be conveyed through its equity-at-risk interest. Therefore, Investment Entity has governing provisions that are the functional equivalent of a limited partnership.

As a result, the variable interest holders evaluate whether the equity-at-risk investors have power using the principles applicable to limited partnerships and similar entities (see section 4.4.30).

Scenario 2: Asset Manager receives a base fee and a performance fee for managing Investment Entity

Asset Manager makes an initial equity investment in Investment Entity and is not permitted to sell its equity interest without the consent of Investment Entity's other investors.

Asset Manager's authority is deemed to be conveyed through its equity-at-risk interest. Therefore, Investment Entity has governing provisions that are the functional equivalent of a limited partnership.

As a result, the variable interest holders evaluate whether the equity-at-risk investors have power using the principles applicable to limited partnerships and similar entities (see section 4.4.30).

Scenario 3: Asset Manager receives a base fee and a performance fee for managing Investment Entity

Asset Manager makes an initial equity investment in Investment Entity and is permitted to sell its equity interest without the consent of the other investors.

Asset Manager's authority is deemed to be conveyed through a non-equity-at-risk interest. Investment Entity may not have governing provisions that are the functional equivalent of a limited partnership and more analysis is required.

As a result, if the variable interest holders conclude that Investment Entity is not similar to a limited partnership, they evaluate whether the equity-at-risk investors have power using the principles applicable to entities other than limited partnerships (see section 4.4.20).

Scenario 4: Asset Manager receives a base fee and a performance fee for managing Investment Entity

The asset management contract requires an affiliate of Asset Manager to make an initial equity investment in Investment Entity and maintain an equity interest of no less than 1% for as long as Asset Manager is the asset manager.

Asset Manager's authority is deemed to be conveyed through the equity-at-risk interest of its affiliate. Therefore, Investment Entity has governing provisions that are the functional equivalent of a limited partnership.

As a result, the variable interest holders evaluate whether the equity-at-risk investors have power using the principles applicable to limited partnerships and similar entities (see section 4.4.30).

General principles for evaluating the second VIE characteristic

Question 4.4.30

What are the steps in evaluating the second VIE characteristic?

Interpretive response: To evaluate whether the equity-at-risk group has the power to direct the legal entity's most significant activities, an enterprise should perform the following steps.

Step 1	Identify the investments that constitute the legal entity's equity at risk (see section 4.3).
Step 2	Consider the equity-at-risk investments together as if they were held by one party.
Step 3	Assess whether these equity-at-risk investments, in the aggregate, provide their investors with the power to direct the activities that most significantly impact the entity's economic performance.

This third step depends on the type of legal entity being evaluated, as described in sections 4.4.20 (legal entities other than partnerships) and 4.4.30 (partnerships and similar entities).

Question 4.4.40

What types of activities demonstrate the power to direct the most significant activities?

Interpretive response: The power held by the equity-at-risk group must enable the equity-at-risk investors to make substantive decisions that most significantly impact the legal entity's economic performance – i.e. the group must have the power to direct the most significant activities. This generally includes the ability to control decisions that affect the entity's revenues, expenses, profits, losses and other key performance indicators. Control over decisions limited to administrative functions generally do not convey power to the equity investors.

Determining whether, as a group, the equity-at-risk investors have the power to direct the most significant activities is based on the applicable facts and circumstances and may entail understanding:

- the legal entity's purpose and design;
- the nature of the legal entity's activities and operations;
- the risks that the legal entity was designed to create and distribute to its interest holders;
- rights provided in contractual and/or governing documents; and
- rights provided through other arrangements (e.g. management or servicing agreements).

Some examples of substantive decisions that collectively may significantly impact a legal entity's economic performance include the ability to enter into new businesses, buy or sell assets and obtain additional financing. Further, we believe the activities that most significantly impact the legal entity's economic performance are the same in applying this second VIE characteristic as they are in determining a VIE's primary beneficiary, if any (see section 6.3).

Relevance of right to receive returns and obligation to absorb losses

When evaluating whether the equity-at-risk group has the power to direct the most significant activities, the variable interest holders consider the extent to which the equity-at-risk group receives residual returns and absorbs expected losses. When equity at risk is significantly larger than expected losses, it is less likely that the equity-at-risk investors would be willing to relinquish such power.

Question 4.4.50

Can the power to direct the most significant activities be conveyed by a non-equity instrument if the instrument is owned by the equity-at-risk group?

Interpretive response: No. Power conveyed to an interest holder through anything other than an equity investment at risk causes the equity-at-risk group to lack the power to direct the most significant activities – i.e. the legal entity is a VIE under the second VIE characteristic. Question 4.4.80 discusses how to evaluate whether the equity-at-risk group has power when decision-making authority has been conveyed through a contractual arrangement.

Example 4.4.20

Equity at risk holders own all the non-equity instruments

Scenario 1: Equity owns less than simple majority voting rights

Investor1 and Investor2 form a venture (Legal Entity) that is capitalized by the issuance of both debt and equity interests. The investors' interests in Legal Entity are as follows.

Investor	Debt interest	Voting interest conveyed by debt interest	Equity interest	Voting interest conveyed by equity interest
Investor1	$ –	N/A	$ 250	25%
Investor2	$ 500	50%	$ 250	25%

All decisions for Legal Entity must be approved by a simple majority vote.

Evaluation

Although the voting interests are entirely held by the equity-at-risk investors through their equity and debt interests, the equity at risk does not convey the power to direct the most significant activities. This is because only 50% (less than a majority) of the voting rights are conveyed via Legal Entity's equity interests. As a result, the entity meets the second VIE characteristic and is therefore a VIE (see Question 4.4.50).

Scenario 2: Equity owns more than simple majority voting rights

Assume the same facts as Scenario 1, except that the investors' interests in Legal Entity are as follows.

Investor	Debt interest	Voting interest conveyed by debt interest	Equity interest	Voting interest conveyed by equity interest
Investor1	$ –	N/A	$ 250	25%
Investor2	$ 450	45%	$ 300	30%

Evaluation

The equity at risk does convey the power to direct the most significant activities. This is because the equity interests hold a 55% vote, which exceeds the simple majority vote needed to make decisions. As a result, the entity does not meet the second VIE characteristic.

Question 4.4.60

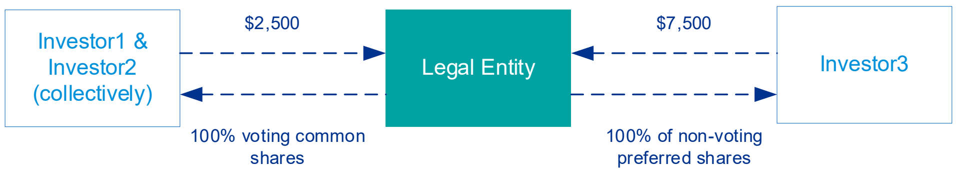
Is the second VIE characteristic triggered if only some equity-at-risk investors have the power to direct the most significant activities?

Interpretive response: No, because the second VIE characteristic is applied to the equity-at-risk investors as a group (instead of than individually). Therefore, all equity-at-risk investors are not required to share power as long as power is held by some of the equity-at-risk investors. [810-10-15-14(b)]

Example 4.4.30
Power held by equity-at-risk group

Background

Three investors form Legal Entity through the following transaction to develop and manufacture a video gaming console.



Assume that all equity investments are at risk and the voting common stock gives its holders the power to direct the most significant activities.

Evaluation

Because all equity investments are deemed to be at risk, the equity investors, as a group, have the power to direct the most significant activities. This power exists even though the investors with voting rights (Investor1 and Investor2) hold only 25% of the outstanding equity at risk.

However, when the voting rights of an equity investor are disproportional to its share of the entity's variability, the enterprise should consider whether the fifth VIE characteristic is present. That characteristic negates the conclusion that the equity-at-risk group has the power to direct the most significant activities (see section 4.7).

4.4.20 Legal entities other than partnerships

Excerpt from ASC 810-10

Variable Interest Entities

> Entities

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase *by design* refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.)

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

1. The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance.

   i. For legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no **owners** hold voting rights or similar rights (such as those of a common shareholder in a corporation). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights (participating rights) as discussed in paragraphs 810-10-25-2 through 25-14 are not VIEs if the holders of the equity investment at risk as a group have the power to control the entity and the equity investment meets the other requirements of the Variable Interest Entities Subsections.

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

This section addresses issues unique to analyzing whether the equity-at-risk group of a legal entity that is **not** a limited partnership (or similar entity) has the power to direct the most significant activities (i.e. the second VIE characteristic). Section 4.4.30 addresses issues unique to this analysis when the legal entity is a limited partnership or similar entity.

If a legal entity is not a limited partnership or similar entity, the equity-at risk group has the power to direct the most significant activities if it can do so through voting rights (or similar rights).

Question 4.4.70

For legal entities other than limited partnerships, are the first and second VIE characteristics based on the same equity at risk investors?

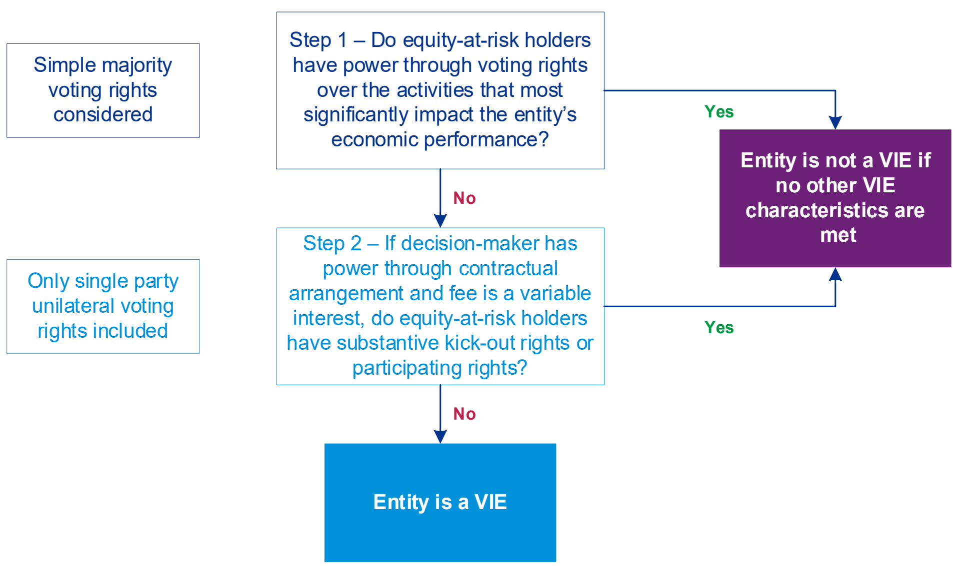
Interpretive response: Yes. For legal entities other than limited partnerships and similar entities (e.g. corporations), the legal entity's equity-at-risk investors are the same for purposes of evaluating: [810-10-15-14(a) – 15-14(b)(1)(i)]

- the first VIE characteristic – i.e. the sufficiency of the legal entity's equity at risk; and
- the second VIE characteristic – i.e. whether the equity-at-risk investors have the power to direct the most significant activities.

Question 4.4.80

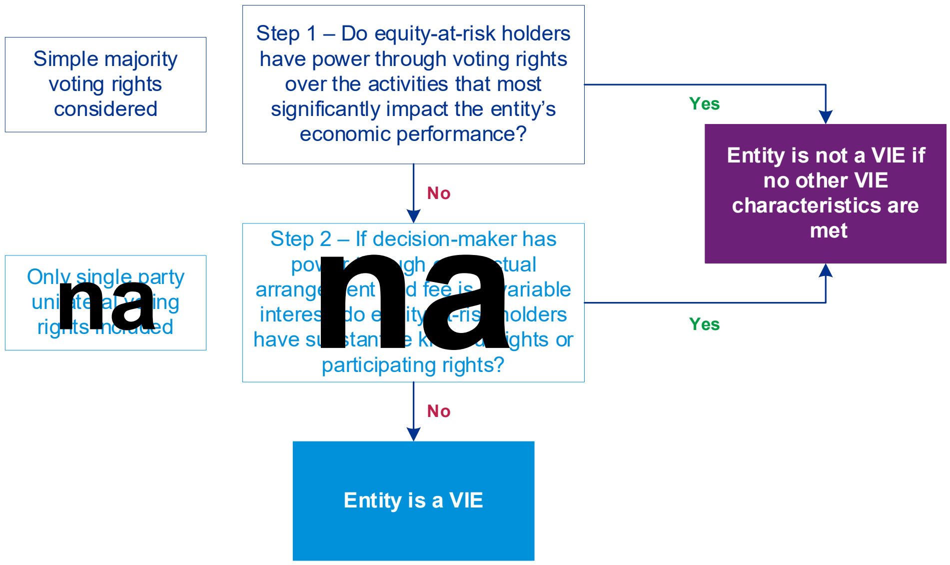
What is the process for evaluating whether equity-at-risk investors have the power to direct the most significant activities of a legal entity that is not a partnership?

Interpretive response: Subtopic 810-10 states that there is a two-step process for evaluating whether the equity-at-risk investors have the power to direct the activities of a legal entity that is not similar to a limited partnership. [810-10-15-14(b)(1)(i), ASU 2015-02.BC35]



However, we are not currently aware of a scenario where the above evaluation would progress to the second step described by the FASB. If the equity-at-risk group does not have power under the evaluation in the first step, it will not have power under the second step either. When voting rights of a single equity-at-risk investor provide that investor a substantive kick-out right or substantive participating right that is unilaterally exercisable, the equity-at-risk investors as a group will have power under the first step and the evaluation will not progress to the second step.

As a result, we believe the analysis can be simplified to a single-step evaluation as illustrated in the following diagram.



If a legal entity is not a limited partnership or similar entity, the equity-at risk group has the power to direct the most significant activities if it can do so through voting rights (or similar) rights.

Evaluating the equity-at-risk group's voting rights: outsourced decision-maker

A legal entity may grant decision-making authority through a contractual arrangement instead of conveying this authority through an equity interest. This 'decision-maker' (see section 3.8) could be a member of the equity-at-risk group or be outside the group. If the contractual arrangement itself is a variable interest, the equity-at-risk group lacks the power to direct the most significant activities if: [810-10-15-14(b)(1)(i)]

— it cannot remove the decision-maker with a simple majority vote – i.e. the equity-at-risk group does not have substantive kick-out rights; and

— it cannot participate in the activities that most significantly affect the legal entity's economic performance with a simple majority vote – i.e. the equity-at-risk group does not have substantive participating rights.

If the equity-at-risk group has either substantive kick-out rights or substantive participating rights over the decision-maker, it has the power to direct the most significant activities – i.e. the second VIE characteristic is not present.

Therefore, the guidance on substantive kick-out rights and substantive participating rights works much the same way for all entities (i.e. whether or not similar to limited partnerships), except that there are related party limitations that apply to limited partnerships and similar entities (see section 4.4.30). [810-10-15-14(b)(1)]

The FASB illustrates this single-step process in Subtopic 810-10 using a series mutual fund as an example (see Question 4.4.90). [810-10-55-8A – 55-8H, ASU 2015-02.BC35]

Evaluating the equity-at-risk group's voting rights: interest holder outside the equity-at-risk group

If the legal entity has granted a unilateral kick-out right or a unilateral substantive participating right to a single interest holder that does not have an equity investment at risk, the equity-at-risk group lacks the power to direct the most significant activities. A substantive participating right is the right to participate in decisions about the activities that most significantly affect the legal entity's economic performance. [810-10-15-14(b)(1)(i)(01), 810-10 Glossary]

Question 4.4.90

What powers constitute the power to direct a fund's most significant activities?

The following guidance in Subtopic 810-10 addresses the activities that most significantly impact the economic performance of a series mutual fund. These are similar to the activities that impact the economic performance of a fund in general.

Excerpt from ASC 810-10

Variable Interest Entities

> Implementation Guidance

>> Example of a Series Mutual Fund

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

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

55-8C The asset management company is compensated on the basis of an established percentage of assets under management in the respective series funds for directing the activities of each fund within its stated objectives. The fees paid to the asset management company are both of the following:

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

55-8D The asset management company has sold 65 percent of the shares in Fund A to external shareholders and holds the remaining 35 percent of shares in Fund A.

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

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

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

55-8G According to paragraph 810-10-15-14(b)(1), one condition for a legal entity to be considered a VIE is that, as a group, the holders of the equity investment at risk lack the power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance. Paragraph 810-10-15-14(b)(1)(i) indicates that, for legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation).

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

Interpretive response: We believe the rights in paragraphs 810-10-55-8E and 55-8F are associated with the VIE definitions of kick-out rights, participating rights, and protective rights as shown in the following table.

Investor rights	Type of right		
	Kick-out	Participating	Protective
Remove and replace the asset manager	✓	✓	
Approve the asset manager’s compensation	✓	✓	
Approve changes to investment strategy			✓
Approve the sale of substantially all of the fund’s assets			✓
Approve a merger/ reorganization of the fund			✓
Approve liquidation or dissolution of the fund			✓
Approve charter and bylaw amendments			✓
Approve an increase in number of authorized shares			✓

The FASB concludes that the shareholders of each series mutual fund have the ability to direct the activities that most significantly impact the fund's economic performance through their voting rights at the series fund-level. [810-10-55-8F – 55-8H]

We believe the FASB arrived at this conclusion because the shareholders can (1) remove and replace the asset manager and (2) approve the asset manager’s compensation with a simple majority vote (see Question 4.4.80). We believe that such rights convey power to the shareholders not only in the case of a series mutual fund, but in an investment fund more generally.

The right to replace the asset manager and approve the asset manager's compensation could meet the definition of either a substantive kick-out right or a substantive participating right. Subtopic 810-10 describes the right to participate in selecting, terminating and setting the compensation of management responsible for implementing the entity's policies and procedures as a substantive participating right. If the asset manager is the equivalent of management responsible for implementing the legal entity's policies and procedures, the right to replace the asset manager and approve the asset manager's compensation generally would qualify as a substantive participating right. More traditionally, this type of right would be considered a substantive kick-out right because the asset manager is a single party with the contractual right (before considering the effect of substantive kick-out rights or substantive participating rights) to make the decisions that most significantly impact the entity's economic performance. [810-10-25-11]

The FASB concludes that substantive kick-out rights (or substantive participating rights) held by the shareholders of each series mutual fund are sufficient to support the conclusion that the shareholders have power. This is true even though the rights are exercisable on a simple-majority voting basis – i.e. there is no single shareholder that can unilaterally exercise those rights.

Question 4.4.100

How does a decision-maker affect whether a legal entity possesses the second VIE characteristic?

Interpretive response: If a legal entity's decision-maker (or service provider with decision-making authority) derives its decision-making authority through an equity investment at risk, see Question 4.4.60. In contrast, if the decision-making authority is not derived through an equity investment at risk, an enterprise has to determine whether the decision-maker's fee arrangement represents a variable interest (see section 3.8).

Fee arrangement is not a variable interest

If the fee arrangement is not a variable interest, the decision-maker or service provider is deemed to be acting in a fiduciary capacity (i.e. as an agent of the equity investors) instead of as a principal to the transaction. In this case, the second VIE characteristic is not present because a decision-maker or service provider acting in a fiduciary capacity could never be the VIE's primary beneficiary (see Question 6.2.30).

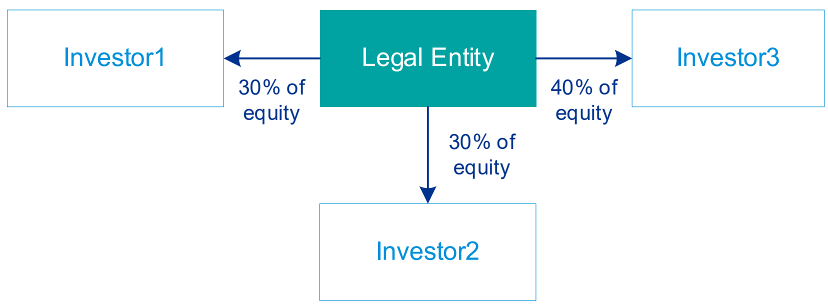
Fee arrangement is a variable interest

If the fee arrangement is a variable interest, the second VIE characteristic is present if the equity-at-risk group is unable to make the decisions that most significantly affect the legal entity's economic performance through its voting (or similar) rights (see Question 4.4.80). [810-10-15-14(b)(1)(i)]

Example 4.4.40
Effect of kick-out or participating rights on investment companies

Background

Investment Fund is established with $20 million of assets under management. There are three unrelated members that hold Investment Fund's equity interests.



Investment Fund hires Asset Manager to monitor the assets it holds and make all decisions related to managing those assets (i.e. the purchase or sale of Investment Fund's assets). Asset Manager is considered the decision-maker and receives a fee for its services. Investment Fund does not possess any of the other VIE characteristics.

Scenario 1: Asset management fee is not a variable interest

The fee paid to Asset Manager is not a variable interest, and Investment Fund's equity-at-risk investors do not have substantive kick-out or participating rights over Asset Manager.

Evaluation

Investment Fund is not a VIE. If the fee paid to Asset Manager is not a variable interest, the equity-at-risk group is deemed to have the power through voting rights or similar rights to direct Investment Fund's most significant activities (see Question 4.4.100). Investment Fund evaluates whether any of the other VIE characteristics are present. If none are present, Investment Fund is evaluated for consolidation as a VOE.

Scenario 2: Asset management fee is a variable interest, equity-at-risk group has no substantive rights

The fee paid to Asset Manager is a variable interest, and Investment Fund's equity-at-risk investors do not have substantive kick-out or participating rights over Asset Manager.

Evaluation

Investment Fund is a VIE. In this scenario, Asset Manager is not part of the equity-at-risk group but has the power to direct Investment Fund's most significant activities. Therefore, as a group, the equity-at-risk investors are deemed to lack the power to direct Investment Fund's most significant activities (see Question 4.4.80), and Investment Fund is evaluated for consolidation as a VIE.

Scenario 3: Asset management fee is a variable interest; equity-at-risk group has substantive rights

The fee paid to Asset Manager is a variable interest, and Investment Fund's equity-at-risk investors have simple majority voting rights over all of the following (1) the replacement of Asset Manager, (2) the approval of Asset Manager's compensation and (3) the investment strategy (see Question 4.4.170).

Evaluation

Investment Fund is not a VIE. The equity-at-risk group is considered to have the power to direct Investment Fund's most significant activities (see Question 4.4.80). Investment Fund evaluates whether any of the other VIE characteristics are present. If none are present, Investment Fund is evaluated for consolidation as a VOE.

Question 4.4.110

Does the equity-at-risk group need unilaterally exercisable rights over a decision-maker to have power to direct the most significant activities?

Interpretive response: No. As discussed in Question 4.4.80, we do not believe that unilaterally exercisable kick-out rights or substantive participating rights over a decision-maker are necessary to conclude that a legal entity of any kind is a VOE. We believe the equity-at-risk group has the power to direct the most significant activities if it can do so through voting (or similar) rights that can be exercised through a simple majority vote.

However, only unilaterally exercisable substantive kick-out rights or substantive participating rights are relevant when evaluating which party, if any, is the primary beneficiary of an entity that is a VIE (see section 6.4).

Example 4.4.50

Kick-out or participating rights held by equity-at-risk group

Background

Three investors create Legal Entity, which is intended to develop and commercialize a new medication. Legal Entity does not qualify for the business scope exception (see section 2.4.50). Each investor contributes the same amount of equity and holds an equal percentage of voting rights (i.e. there is no disproportionality between voting rights and economic rights), which are substantive.

Legal Entity does not possess any of the other VIE characteristics because:

— each investor's equity investment meets the requirements to be considered at-risk, and Legal Entity has sufficient equity at risk to finance its activities without additional subordinated financial support; and

— the investors are not protected from absorbing Legal Entity's expected losses and have the right to receive Legal Entity's expected residual returns.

The investors hire an unrelated third-party manager to oversee the R&D activities. The venture agreement requires a simple majority of the voting rights to approve the following decisions: the removal of the manager, the compensation of the manager and Legal Entity's strategy. The fees paid to the manager represent a variable interest.

Evaluation

The venture agreement requires a vote of no more than two of the three investors to approve the removal of the manager, the compensation of the manager and Legal Entity's strategy. Therefore, the three investors as a group have the power to direct Legal Entity's most significant activities. Because Legal Entity also has no other characteristics of a VIE, it is not a VIE.

Note: This conclusion does not change if the fee paid to the manager is not a variable interest – even if the three investors as a group do not have substantive kick-out or participating rights over the manager. If the manager's fee arrangement is not a variable interest, the manager is deemed to be acting as an agent for the equity-at-risk group.

Question 4.4.120

Do kick-out or participating rights held by non-equity interests always trigger the second VIE characteristic?

Interpretive response: No. Kick-out or participating rights can be held by non-equity interest holders (or by at-risk holders through non-equity instruments, see Question 4.4.50).

As discussed in Question 4.4.80, such rights only prevent the equity-at-risk group from possessing the power to direct the most significant activities (and therefore trigger the second VIE characteristic) if they: [810-10-15-14(b)(1)(i)]

— are unilaterally exercisable – i.e. exercisable by a single party, including its related parties and de facto agents (see sections 6.4 and 6.5); and
— relate to the activities that most significantly impact the legal entity's economic performance.

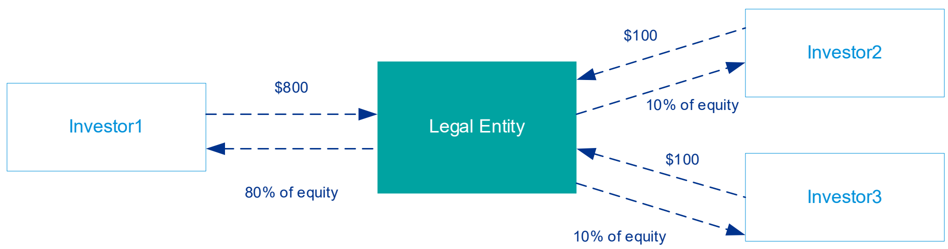
We believe that a non-equity at risk interest holder's ability to block the actions through which the equity-at-risk group may exercise power is a substantive participating right. However, if that participating right is held collectively by multiple unrelated parties through interests that are not equity investments at risk, the equity-at-risk group does not lack the power to direct the most significant activities.

It is unusual in practice for non-equity interest holders to possess unilaterally exercisable kick-out rights or participating rights conveying power.

Example 4.4.60
Rights held by non-equity at risk variable interest holders (1)

Background

Legal Entity is formed by three unaffiliated investors through the following transaction.



— Investor2 and Investors3 have the ability to put (sell) their equity interests to Investor1 after three years for the amount of their initial equity contributions.

— Because Investor2 and Investor3 have the ability to put their equity interests back to Investor1, their interests are not considered equity at risk; they are protected from participating significantly in Legal Entity's losses (see section 4.3.30).

Scenario 1: Unilateral right to block significant decisions by a non-equity-at-risk holder

Investor1 has all substantive decision-making rights. However, Investor3 has the right to block any of Investor1's decisions.

Evaluation

Investor1 lacks the power to direct the most significant activities because Investor3 can unilaterally block all of its actions – i.e. Investor3 has substantive participating rights.

Because Investor3 possesses substantive participating rights through a non-equity-at-risk investment, Legal Entity is a VIE.

Scenario 2: Collective right to block decisions by a vote of the non-equity-at-risk holders

Investor1 has all substantive decision-making rights. However, Investor2 and Investor3 can block any of Investor1's decisions if they both agree to do so.

Evaluation

Investor1 has the power to direct the most significant activities because no party outside the equity-at-risk group has unilateral kick-out rights or substantive participating rights.

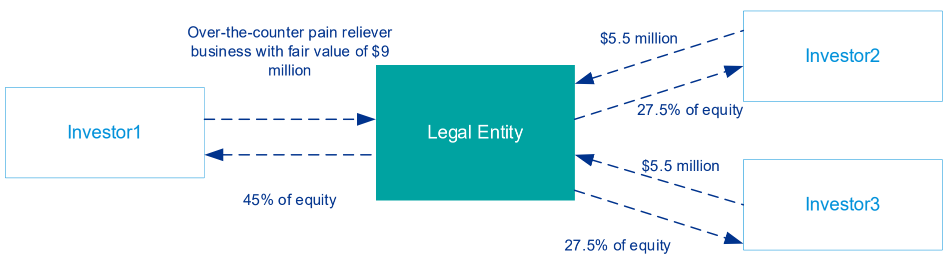
Because the participating rights are held collectively by multiple unrelated parties, we believe Investor1 has the power to direct the most significant activities and therefore Legal Entity is not a VIE (see Question 4.4.120).

Example 4.4.70

Rights held by non-equity at risk variable interest holders (2)

Background

Investor1 forms a venture (Legal Entity) with Investor2 and Investor3 through the following transaction to manufacture and distribute over-the-counter pain relievers.



Investor3 has the ability to put (sell) its equity interest to Investor1 for the amount paid ($5.5 million) after the third year. Investor3’s equity investment is not at risk because the put option protects it from participating significantly in Legal Entity's losses (see section 4.3.30).

Scenario 1: Unilateral right to block significant decisions by a non-equity-at-risk holder

Legal Entity’s legal documents require all decisions to be determined based on a unanimous vote by all three equity investors.

Evaluation

Investor3 does not have an equity investment at risk and has the substantive ability to block all decisions (because of the requirement for a unanimous vote). The equity-at-risk group lacks the power to direct the most significant activities because Investor3 has substantive participating rights. Therefore, Legal Entity is a VIE.

Scenario 2: Unilateral right to block insignificant decisions by a non-equity-at-risk holder

Legal Entity’s legal document allows Investor3 to vote only on decisions other than those that most significantly impact Legal Entity's economic performance.

Evaluation

Because Investor3 can vote only on decisions other than those that most significantly impact Legal Entity's economic performance, its rights are protective, not participating. Therefore, the equity-at-risk group has the power to direct the most significant activities.

Because Investor3 possesses only protective rights through a non-equity-at-risk investment, Legal Entity is a not VIE.

Example 4.4.80
Multi-seller commercial paper conduit

Background

Legal Entity is a multi-seller commercial paper conduit. Various entities transfer interest-bearing trade accounts receivable, notes receivable or loans receivable to Legal Entity, and Legal Entity simultaneously issues commercial paper to pay the transferors for the financial assets.

Legal Entity's only equity interest is approximately 10 basis points of its initial total capital (including the commercial paper). The investor in that equity investment is not a related party of any of the transferors. The return on the equity investment represents a fee paid to facilitate the existence of the structure.

The following parties are involved with the commercial paper conduit.

Transferors:	The entities that transfer the financial assets.
Administrator:	The entity that places and services the commercial paper, provides a back-up letter of credit, a liquidity letter of credit and a second loss guarantee.
Investor:	The holder of the equity interest.
CP holders:	The holders of the commercial paper issued by the conduit.

Transferors: Transferors receive $0.90 for each $1 dollar of financial assets transferred. Each transferor also obtains the right to any excess of the ultimate collections on the financial assets it transfers over the amount necessary to repay the commercial paper obligation and a proportionate share of the conduit's expenses. That excess is referred to as excess collateral on the commercial paper.

Each transferor is obligated to service the financial assets it transferred. Each transferor's rights and obligations relate to only the assets it transferred and no single transferor transfers into Legal Entity a majority of Legal Entity's total assets.

The transferors have no risk of loss or right to benefits related to assets transferred by other transferors and no obligation to transfer additional assets under any circumstance.

Administrator: The administrator decides which receivables to buy, the level of excess collateral required from each transferor, and the monitoring fee that will be charged to each transferor.

Administrator also places the commercial paper with investors and makes the required payments, pays the expenses of the conduit, reports to Transferors and Investor and provides other necessary administrative services in exchange for an incremental administrative fee.

All of Administrator's fees are commensurate with those in other similar structures in the marketplace.

Investor: Investor receives a fee for facilitating the existence of Legal Entity.

CP holders: CP holders have the right to receive specified amounts of cash at specified times. Because of the excess collateral and various other forms of credit risk protection, CP holders bear very little risk and consequently receive a relatively low rate of return.

Evaluation

Investor lacks the power to direct the most significant activities because Administrator has the unilateral right to make those decisions. Because Administrator has that power through a non-equity-at-risk investment, the second VIE characteristic is triggered and therefore Legal Entity is a VIE.

Question 4.4.130

Is a franchisee a VIE if the franchise agreement limits the equity investors' decision-making rights?

Interpretive response: Many franchise agreements have provisions that limit certain decision-making rights of the equity investor(s) in the franchisee. When evaluating whether the equity-at-risk group has the power to direct the most significant activities, it is important to determine whether the limitations imposed by the franchisor are necessary to protect the franchisor's brand.

In a typical franchise arrangement, the franchisor is effectively licensing its brand to the franchisee for a specified period of time and therefore is likely to require certain decision-making rights to ensure that the level of quality associated with the franchisor's brand is maintained. These franchisor rights do not necessarily limit the franchisee investor's power to direct the most significant activities.

For example, a franchise agreement may allow the franchisor to participate in the following decisions (not exhaustive):

— the right to approve the location of the retail facility or geographic area in which the franchisee is permitted to operate;

— the right to require equipment, signs, menu boards, supplies and other items necessary in connection with adding new approved products to be acquired, installed and used at the retail facility as soon as possible consistent with franchisor requirements;

— the right to approve the products that may be sold at the retail facility;

- the right to approve suppliers for purchases of inventory, advertising materials, training materials, uniforms, packaging, computer hardware, insurance, and all food and beverage ingredients and products;
- the right to approve the days and hours of operation;
- the right to approve the franchisee's marketing plan;
- the right to approve relocation of a retail facility; and
- the right to approve a sale of the franchise.

Although many of these decisions are important to the economic performance of the franchisee, the franchisor's ability to participate in those decisions does not necessarily result in the equity-at-risk group lacking the power to direct the franchise’s most significant activities. By entering into a franchise agreement, a franchisee has made a unilateral decision to operate its business in a specific location under a common trademark and system, and at the same time to adopt the franchisor's business standards.

The franchisor's right to enforce its business standards does not necessarily cause a franchisee to be a VIE. The power to direct the most significant activities exists if the franchisee’s equity-at-risk group maintains control over decisions that most significantly impact the economic performance of the franchisee and these decisions are substantive in nature – i.e. they have a direct effect on revenues, expenses, gains, losses, etc.

Specifically, we believe the equity-at-risk group must have decision-making ability over areas that are not included in the franchise agreement – e.g. the day-to-day operations of the franchise. This generally includes, but is not limited to:

- hiring, firing and supervising of management and employees;
- establishing what prices to charge for products or services; and
- making capital decisions of the franchise.

Control over the following types of fundamental decisions may also be important to the franchisee’s economic performance: the form (e.g. corporate, LLC, LLP, partnership) of the franchisee, its charter and how it is capitalized.

Note: If a franchisee is formed as a limited partnership or similar entity, an enterprise would evaluate it under a different set of principles (see section 4.4.30).

The franchisor may provide financial support to the franchisee or otherwise limit the franchisee investor's obligation to absorb expected losses or receive expected residual returns. In these situations, the power to direct the franchisee’s most significant activities becomes increasingly important to the franchisor because of the additional risk borne by the franchisor. Even if the amount of equity at risk exceeds the franchisee’s expected losses (thereby mitigating the risk to the franchisor), the franchisor may still require the franchisee to provide it the right to make all decisions that have a significant effect on the franchisee’s economic performance. In that case, the equity-at-risk group would not have the power to direct the most significant activities and, as a result, the franchisee would be a VIE.

In other situations, the franchisor may require the franchisee to relinquish some, but not all, of its ability to make decisions that have a significant effect on the franchisee's economic performance. In such cases, an enterprise should consider all relevant facts and circumstances when determining whether the equity-at-risk group has the power to direct the most significant activities. The amount of the franchisee's equity at risk compared to its expected losses may be a strong indicator as to whether this condition is met.

Question 4.4.140

Can the equity-at-risk group have the power to direct the most significant activities through the right to elect a board of directors?

Interpretive response: Yes. If there is a substantive process whereby the board of directors is elected by a simple majority vote of the equity-at-risk group and the board is acting on the group's behalf, the rights of the board of directors are evaluated as rights of the equity-at-risk group.

In that case, the equity-at-risk group has the power if: [ASU 2015-02.BC35]

— the board of directors is actively involved in making decisions about the activities that most significantly impact the legal entity's economic performance; and

— there is a regular periodic process for the equity-at-risk group to make changes to the board members.

A board's delegation of the day-to-day execution of its decisions to a management team or third-party decision-maker does not preclude a conclusion that the board is actively involved in making significant decisions. The board can still have this power on behalf of the equity-at-risk group if there is a frequent and sufficiently detailed reporting mechanism whereby it is able to monitor the performance of the management team or decision-maker on a timely basis. Further, in those situations, the board should have the right to replace the management team or decision-maker without cause and approve their compensation.

Example 4.4.90

Investment advisory entities designed to comply with the risk retention rules

Background

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC and other regulators to prescribe rules requiring many sponsors of securitizations of asset-backed securities (ABS) to retain a portion of the credit risk of the assets collateralizing the asset-backed securities. Unless an exemption applies, under the Risk Retention Rules, sponsors of securitizations that issue ABS must retain an eligible horizontal residual interest (as defined in the rules), or an eligible vertical interest (as defined by the rules), or a combination of both.

In some situations, a reporting enterprise (the founding enterprise) may create an investment advisory entity, referred to as a Capitalized Manager Vehicle (CMV), to sponsor a securitization of ABS under the Risk Retention Rules. The CMV may be created for a variety of reasons, including eliminating the founding enterprise's role as the sponsor of the securitization. Eliminating this role may be necessary to address capital adequacy considerations applicable to founding enterprises that are financial institutions – i.e. the required retained interests under the Risk Retention Rules may negatively affect certain capital adequacy tests.

Each CMV may have its own unique characteristics and reporting enterprises may have different economic interests in CMVs they are involved with. However, we understand that some CMVs and involvement with CMVs by a founding enterprise have the following characteristics.

- The CMV is entirely equity capitalized largely by parties unrelated to the founding enterprise with no individual investor owning more than 25% of the CMV's equity. All equity investments are classified by the CMV as permanent equity.
- The founding enterprise holds no more than 10% of the CMV's equity and is not committed to make any future investments in the CMV.
- All significant operating and capital decisions of the CMV are controlled by majority vote of the entity's board of directors comprising a majority of individuals selected by parties unrelated to the founding enterprise.
- The day-to-day activities of the CMV are conducted by an investment committee appointed by and subject to removal by majority vote of the CMV's board of directors. Although employees of the founding enterprise may serve on the investment committee, the investment committee will be solely responsible for carrying out the decisions reached by the CMV's board of directors.
- Certain personnel, credit analysis, loan management, middle office, back office and other services may be provided by the founding enterprise subject to the ongoing approval of a majority of the CMV's board of directors. The founding enterprise will receive a percentage of the fixed management fee earned by the CMV on securitizations of ABS the CMV sponsors and manages.
- The CMV is expected to invest in ABS issued by securitizations it sponsors and manages to comply with the Risk Retention Rules.

Evaluation

Each reporting enterprise needs to evaluate a CMV or similar entity it is involved with based on its specific facts and circumstances. However, the SEC staff has not objected to a founding enterprise registrant's conclusion to not consolidate a CMV it created with the characteristics described in the background. [2015 AICPA Conf]

In the fact pattern described in the background, we understand the SEC staff's reasons for accepting that the CMV was not a VIE are as follows.

First VIE characteristic: Insufficient equity at risk

The structure is capitalized by a significant investment by third-party investors and only limited investment by the founding enterprise – i.e. 10% or less of the CMV's equity. Further, the founding enterprise has no explicit or implicit commitment to make additional investments in the CMV.

Those factors support the conclusion that the CMV's total equity at risk is sufficient to permit the CMV to finance its activities without additional subordinated financial support – i.e. the first VIE characteristic is not present (see section 4.3).

Second VIE characteristic: Lack of power to direct activities

The CMV is not considered to be the functional equivalent of a limited partnership (see Question 4.4.10) because there is no one party responsible for managing the entity's operations. As a result, the CMV is evaluated under the principles applicable to entities other than limited partnerships.

The equity-at-risk group has the power to direct the CMV's most significant activities because:

- the board of directors is controlled by parties unrelated to the founding enterprise and the board controls the actions of the investment committee; and
- the activities undertaken by the founding enterprise are limited to administrative activities subject to ongoing approval by a majority of the board of directors.

As a result, the second VIE characteristic is not present.

None of the other VIE characteristics are present in the CMV. As a result, the CMV is not a VIE. Because the CMV is not a VIE, it should be evaluated for consolidation using the VOE consolidation model. See Question 5.2.100 for guidance and conclusion.

Question 4.4.150

Are liquidation rights considered kick-out rights under the VIE definition?

Interpretive response: Yes. This question was addressed by the FASB in the basis for conclusions to ASU 2015-02, which states the following. [ASU 2015-02.BC49]

Excerpt from ASU 2015-02

BC49. In deliberating the proposed amendments in the 2011 Exposure Draft, the Board decided that liquidation rights should be considered equivalent to kick-out rights. Liquidation rights provide the holders of such rights with the ability to dissolve the entity and, thus, effectively remove the decision-maker's authority. The Board considered evaluating liquidation rights in a manner similar to kick-out rights only when it is reasonable that upon liquidation, the investors will receive substantially all of the specific assets under management and can find a replacement manager with sufficient skills to manage those assets. The basis for this view is that it may be less likely for the holders to exercise their liquidation rights if they would not receive the assets under management or if they would be unlikely to find a replacement for the current decision-maker. The Board ultimately rejected this view because the outcome for the decision-maker is the same regardless of whether the holders of those rights have the ability to obtain the specific assets from the entity upon liquidation or identify an alternative manager. If the holders exercise their substantive liquidation rights, similar to kick-out rights, the decision-maker's abilities would be removed. Barriers to exercise may be different when considering kick-out rights as compared with barriers for liquidation rights and should be evaluated appropriately when assessing whether the rights are substantive. The Board's decision was consistent with the definition of kick-out rights originally included in Subtopic 810-20.

See Question 6.4.80 for guidance on evaluating liquidation rights when identifying the primary beneficiary of a VIE, and Question 5.2.150 for guidance on evaluating them when identifying the party with the power to control a VOE. In some cases, liquidation rights may be exercisable at a future date (see Question 6.4.100).

Question 4.4.160

Are redemption (withdrawal) rights considered the equivalent of kick-out rights under the VIE definition?

Interpretive response: Generally, no. Withdrawal rights that do not either explicitly or implicitly require dissolution or liquidation of the entity are not considered similar to a substantive kick-out right. However, in rare situations withdrawal rights may implicitly require liquidation of a legal entity and therefore function similarly to substantive kick-out rights.

The following is an example of such a rare situation. Investor holds a substantial portion of the investment interests in a fund with illiquid investments. Should Investor exercise its withdrawal right, the fund would be compelled to liquidate all of its investments to satisfy that withdrawal right. If there are no significant barriers to Investor's exercise of the withdrawal right, the withdrawal right functions similarly to a substantive kick-out right.

This is consistent with the FASB's intentions as described in the basis for conclusions to ASU 2015-02 (see below). [ASU 2015-02.BC53 – BC54]

See Question 6.4.90 for guidance on evaluating withdrawal rights when identifying the primary beneficiary of a VIE, and Question 5.2.160 for guidance on evaluating them when identifying the party with the power to control a VOE.

Excerpt from ASU 2015-02

BC53. …[T]he Board also reconsidered whether redemption rights should be considered equivalent to kick-out rights. Redemption rights represent an entity's obligation to return provided capital to an investor upon the investor's request. While redemption rights do not provide an investor with the power to remove a decision-maker, stakeholders pointed out that in some situations redemption may require liquidation of all of the entity's assets if exercised. Investors could theoretically withdraw 100 percent of an entity's capital (assuming there are no restrictions in place) and effectively kick out the decision-maker. While this scenario may be rare in circumstances with many investors, it might be plausible for an entity that has few investors.

BC54. During redeliberations, the Board considered treating kick-out and redemption rights in a similar manner in certain circumstances depending on their effectiveness, but it ultimately concluded that redemption rights are not the equivalent of kick-out rights. The Board observed that while the exercise of redemption rights may occasionally lead to liquidation, those rights are inherently different from liquidation rights or kick-out rights and the economics are not the same. The Board questioned why a reporting entity would not just provide kick-out rights in a situation in which redemption rights would be clearly equivalent. The Board's conclusion is consistent with the guidance previously included in paragraph 810-20-25-9, which states that "... the limited partners' unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that the general partners control the limited partnership...." This paragraph has been amended and moved to paragraph 810-10-25-14B.

Question 4.4.170

Is the right to vote on the investment strategy of a fund always a participating right?

Interpretive response: No. In its series mutual fund example, the FASB stated that the shareholders' right to vote on the investment strategy of a series mutual fund is one of the reasons the shareholders have power through voting rights (see Question 4.4.90). However, we believe that right meets the definition of a protective right. [810-10-55-8H]

Specifically, the investment strategy of a mutual fund is generally established at its formation by its sponsor or advisor before investment interests are sold to third parties. Further, the investment strategy of a mutual fund is part of its design and is usually general in nature – i.e. there usually are numerous investments that are consistent with a mutual fund's investment strategy. [810-10-55-8B]

We believe that acceptance of the investment strategy is generally a decision to invest, not a right that conveys power over the activities that most significantly impact the economic performance. The selection of specific investments (which shareholders do not generally have the right to approve) is what usually significantly impacts a mutual fund's economic performance. Once established, a mutual fund's investment strategy would not be expected to change.

Therefore, we believe a shareholder's right to vote on the investment strategy after making an initial investment decision is consistent with the definition of a protective right. Shareholders need not have protective rights to have the power to direct the activities that most significantly impact a legal entity's economic performance. [810-10-15-14(b)(1), 55-8B, 55-8H]

Question 4.4.180

For legal entities other than limited partnerships, does an enterprise evaluate power the same way for assessing the second VIE characteristic and identifying the primary beneficiary?

Interpretive response: Not necessarily. The evaluation of the second VIE characteristic for corporations and other entities that are not similar to limited partnerships differs from limited partnerships and similar entities. Subparagraph 810-10-25-38A(b) regarding the identity of the VIE's primary beneficiary does not make this distinction.

Further, for legal entities that are not similar to limited partnerships, the equity-at-risk group has power for purposes of evaluating the second VIE characteristic if the equity-at-risk group can:

— kick out a decision-maker with a variable interest; or

— participate in the decisions that most significantly impact the legal entity's economic performance though a simple majority (or lower threshold) vote (see Question 4.4.80). [810-10-15-14(b)(1)(i)]

This differs from how an enterprise considers kick-out rights and participating rights when identifying the individual entity with power over the VIE – i.e. the primary beneficiary of the VIE. In that analysis, a decision-maker with a variable interest has power unless a single party (or single group of related parties and de facto agents) has the unilateral ability to exercise such rights (see section 6.4). [810-10-25-38A(a)]

See chapter 6 for additional guidance on the primary beneficiary determination.

4.4.30 Partnerships and other similar entities

Excerpt from ASC 810-10

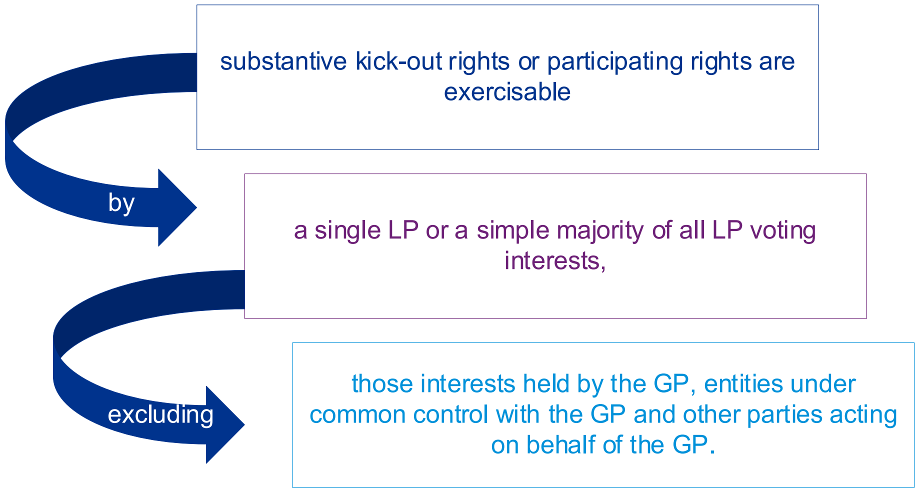
Variable Interest Entities

> Entities

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase *by design* refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.)

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

A limited partnership or similar entity possesses the second VIE characteristic – the lack of power by its partners to direct the partnership's most significant activities – and therefore is a VIE unless: [810-10-15-14(b)(1)(ii)]



Question 4.4.190

For limited partnerships and similar entities, are the first and second VIE characteristics based on the same equity at risk investors?

Interpretive response: No. Voting equity-at-risk interests held by the following parties are treated differently under the first and second VIE characteristics:

- GP (or equivalent);
- entities under common control with the GP (see Question 3.8.230); and
- other parties acting on behalf of the GP (or equivalent).

These parties are included in evaluating the first VIE characteristic – i.e. sufficiency of a legal entity's equity at risk. However, they are removed from the equity-at-risk group when evaluating the second VIE characteristic – i.e. whether the equity-at-risk group has the power to direct the most significant activities. [810-10-15-14(a), 15-14(b)(1)(ii)]

Question 4.4.200

What is the process for evaluating whether equity-at-risk investors have the power to direct the most significant activities over a partnership or similar entity?

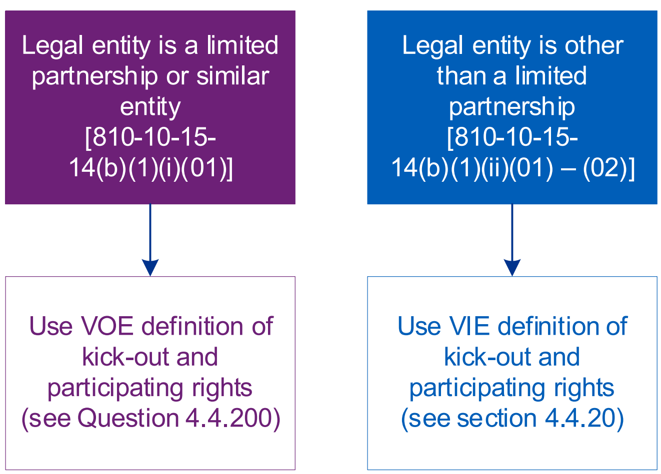
Interpretive response: A limited partnership's equity-at-risk group lacks the power to direct the partnership's most significant activities unless a simple majority (or lower threshold) of the equity-at-risk partners have substantive kick-out rights or participating rights. An enterprise uses the VOE consolidation guidance when identifying kick-out and participating rights and evaluating whether those rights are substantive (see Question 4.4.210). Chapter 5 provides guidance on evaluating whether kick-out and participating rights are substantive under that guidance. [810-10-15-14(b)(1)(ii)]

When computing the percentage of LP interests necessary to exercise the kick-out or participating rights, an enterprise removes the LP interests held by the GP, parties under common control with the GP (see Question 3.8.230) and other parties acting on behalf of the GP. [810-10-15-14(b)(1)(ii)(01)(A)]

Question 4.4.210

Are there differences in how kick-out rights and participating rights are evaluated for corporations vs limited partnerships and similar entities?

Interpretive response: Yes. There are two definitions of kick-out rights and participating rights. Which definition to use when evaluating whether the equity-at-risk group has the power to direct the legal entity's most significant activities depends on the nature of the legal entity.



The VIE definition of kick-out rights is closely aligned with the VOE definition of kick-out rights, because Subtopic 810-10 equates liquidation rights to kick-out rights in the VIE definition.

However, the VIE and VOE definitions of participating rights differ in important respects. [810-10 Glossary]

— VIE definition. Participating rights relate to the ability to block or participate in the actions through which an enterprise exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance.

— VOE definition. Definition of participating rights focuses on certain significant financial and operating decisions that are made in the ordinary course of business.

Rights in the ordinary course of business may also represent participating rights for legal entities other than limited partnerships if the activities subject to these powers most significantly impact the legal entities' economic performance. This is more likely to be true for legal entities with substantive ongoing business operations than for other legal entities. However, an enterprise should consider all relevant facts and circumstances, including the level at which these powers operate.

For example, the ability to approve operating and capital budgets may not remove power from the servicer of a collateralized financing entity if significant decisions about default mitigation cannot be significantly influenced through the budget process. Ultimately, a substantive participating right for a legal entity other than a limited partnership must provide the holder the right to participate in making the decisions that most significantly impact the legal entity's economic performance.

Chapter 5 provides guidance on evaluating whether kick-out and participating rights are substantive under the VOE consolidation guidance.

Question 4.4.220

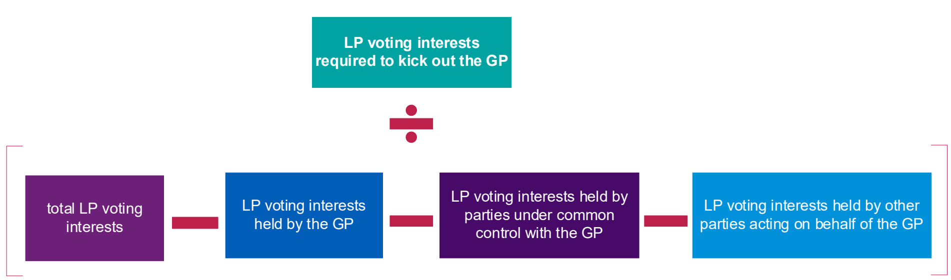
How are simple majority kick-out rights calculated when the GP holds an LP interest?

Background: For a limited partnership, kick-out rights held by the following parties are not included when evaluating whether a simple majority (or lower threshold) of LPs with equity at risk have substantive kick-out rights: [810-10-15-14(b)(1)(ii)]

— GP;
— entities under common control with the GP; and
— other parties acting on behalf of the GP.

Interpretive response: The denominator in the simple majority calculation is affected when the GP, parties under common control with the GP (see Question 3.8.230) or other parties acting on behalf of the GP hold an LP interest.

The following formula is used to calculate whether a simple majority (or lower threshold) has the right to kick out the GP without cause. Evaluation of this requirement is applicable regardless of the level of the GP's ownership of the LP interests. [810-10-15-14(b)(1)(ii)]



Because the denominator of the calculation decreases with each LP voting interest held by the GP (or by parties under common control with or acting on behalf of the GP), a limited partnership becomes more likely to be a VIE as the GP's holdings of LP interests rise. For example, GP owns 1 of 100 LP interests and the partnership agreement requires 51 LP votes to kick out the GP. There is no simple majority kick-out right (and the partnership is a VIE) because it takes more than a simple majority of the 99 LP interests that are not held by the GP to remove the GP.

Example 4.4.100
GP does not hold an LP interest

Background

Limited Partnership has 100 LPs that collectively hold all of its LP interests. Each LP receives voting interests equal to its percentage share of the total LP interests.

The LPs do not have substantive participating rights. However, the partnership agreement states that the LPs may kick out the GP without cause based on a simple majority of the LP voting interests.

None of the LPs are under common control with the GP or acting on behalf of the GP. The GP also does not hold any LP interests.

Evaluation

The LPs have a simple majority kick-out right (51%), calculated as follows: 51 ÷ (100 - 0).

If the kick-out rights meet the other conditions to be considered substantive, the LPs have the power through voting rights or similar rights to direct the activities that most significantly impact Limited Partnership's economic performance.

If none of the other VIE characteristics are present, Limited Partnership is a VOE.

Example 4.4.110
GP holds an LP interest

Background

Limited Partnership has 100 LPs that collectively hold all of its LP interests. Each LP receives voting interests equal to its percentage share of the total LP interests.

The LPs do not have substantive participating rights. However, the partnership agreement states that the LPs may kick out the GP without cause based on a simple majority of the LP voting interests.

The GP holds 10% of the LP interests.

Evaluation

Approval of 57% (51 ÷ [100 - 10]) of the LP voting interests, excluding interests held by the GP, parties under common control with the GP, or other parties acting on behalf of the GP is required to kick out the GP without cause.

Because 57% is more than a simple majority, the LPs lack the power through voting rights or similar rights to direct Limited Partnership's most significant activities. Therefore, Limited Partnership is a VIE.

Question 4.4.230

When are other parties that hold LP interests acting on behalf of the GP?

Background: For a limited partnership, kick-out rights held by the following parties are not included when evaluating whether a simple majority (or lower threshold) of LPs with equity at risk have substantive kick-out rights: [810-10-15-14(b)(1)(ii)]

- GP;
- entities under common control with the GP (see Question 3.8.230); and
- other parties acting on behalf of the GP.

Interpretive response: An enterprise should consider the facts and circumstances when determining whether an LP is acting on behalf of the GP in exercising its LP voting rights, including:

- the purpose and design of the limited partnership and the investment objective of the LP;
- other relationships between the GP and the LP and whether those relationships may compel the LP to act on behalf of the GP; and
- contractual or legal requirements that may affect the LP's ability to exercise its kick-out right.

Judgment and an evaluation of all relevant facts and circumstances is required to determine whether other relationships (e.g. related party and de facto agency relationships) between the GP and LP compel the LP to act on behalf of the GP. For example, we believe that generally employees of the GP would be compelled to act on behalf of the GP absent strong evidence to the contrary.

Question 4.4.240

Is a nominal investment by a GP relevant when evaluating kick-out or participating rights?

Background: An equity investment must be substantive for it to be considered at risk. A nominal investment generally is not considered substantive (see Question 4.3.30). [810-10-15-14(a)]

Interpretive response: Generally, no. The evaluation of power is based solely on whether substantive kick-out rights or participating rights are exercisable by either a single LP or a simple majority of all LP voting interests. Excluded from this determination are LP voting interests held by the GP, entities under common control with the GP (see Question 3.8.230) and other parties acting on behalf of the GP. [810-10-15-14(b)(1)(ii)]

However, in some cases, a nominal investment by the GP may strengthen the rights held by the LP. For example, a right that allows an LP to buy out a GP for only minor consideration (commensurate with its investment) may be a substantive kick-out or participating right (see Question 5.3.60).

Question 4.4.250

For limited partnerships and similar entities, does an enterprise evaluate power the same way when assessing the second VIE characteristic and identifying the primary beneficiary?

Interpretive response: Not necessarily. The evaluation of the second VIE characteristic for corporations and other entities that are not similar to limited partnerships differs from limited partnerships and similar entities. Subparagraph 810-10-25-38A(b) regarding the identity of the VIE's primary beneficiary does not make this distinction.

Further, for purposes of evaluating the second VIE characteristic, the equity-at-risk group has power if its LP interests can:

— kick out the GP/decision-maker that has a variable interest; or
— participate in the activities that occur in the **ordinary course of business by** exercising **a simple majority** (or lower threshold) vote (see Question 4.4.200).

In this case, the equity-at-risk group excludes any LP interests held by the GP, entities under common control with the GP (see Question 3.8.230), or parties acting on behalf of the GP. [810-10-15-14(b)(1)(ii)]

This differs from how an enterprise considers kick-out rights and participating rights when identifying the individual entity with power over the VIE – i.e. the primary beneficiary of the VIE. In that analysis, a decision-maker that has a variable interest has power unless a single party (or single group of related parties and de facto agents) has the unilateral ability kick out the decision-maker or participate in the activities that most significantly impact the entity's economic performance (see section 6.4). [810-10-25-38A(a)]

See chapter 6 for additional guidance on the primary beneficiary determination.

4.4.40 FASB examples

Subtopic 810-10 illustrates how to assess whether LPs hold simple majority kick-out rights.

Excerpt from ASC 810-10

General

> Implementation Guidance

>> Assessing Partner Kick-Out Rights

>>> Example 3: Simple Majority Threshold for the Application of Kick-Out Rights

55-4N This Example illustrates the guidance in paragraph 810-10-15-14(b)(1)(ii). Cases A, B, C, F, and G illustrate arrangements in which the limited partnership agreement requires a simple majority vote of the limited partnership's kick-out rights through voting interests to remove the general partner and the general partner cannot vote. Cases D and E demonstrate arrangements in which the limited partnership agreement requires a two-thirds vote and a unanimous vote, respectively, of the limited partnership's kick-out rights through voting interests to remove the general partner and the general partner cannot vote. To illustrate the application of the thresholds to exercise kick-out rights through voting interests for limited partnerships in paragraph 810-10-15-14(b)(1)(ii)(01), consider the following cases:

a. Three equal-interest limited partners (Case A)
b. Two equal-interest limited partners (Case B)
c. One hundred equal-interest limited partners (Case C)
d. Required limited partner voting percentages of more than a simple majority (Case D)
e. Four equal-interest limited partners with a required unanimous vote of the limited partnership's kick-out rights through voting interests (Case E)
f. Limited partner and general partner with a required simple majority percentage of the limited partnership's kick-out rights through voting interests—limited partner consolidates (Case F)
g. Four equal-interest limited partners with a required simple majority percentage of the limited partnership's kick-out rights through voting interests—no partner consolidates (Case G).

>>>> Case A: Three Equal-Interest Limited Partners

55-4O Assume that a limited partnership has 3 limited partners, none of which have any relationship to the general partners, and that each holds an equal amount of the limited partnership's kick-out rights through voting interests (33.33 percent). In this Case, applying the simple majority requirement in the partnership agreement would require a vote of no more than two of the three limited partners to remove the general partners. Presuming the **kick-out rights** are substantive, a limited partnership that entitles any individual limited partner to remove the general partner or a limited partnership that requires a vote of two of the limited partners to remove the general partner would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership's economic performance. Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a variable interest entity (VIE), the limited partnership would be considered a voting interest entity. However, if a vote of all three limited partners is required to remove the general partner and the limited partners do not possess substantive participating rights, the limited partnership would meet the condition in paragraph 810-10-15-14(b)(1)(ii) because the required vote is more than a simple majority of the limited partnership's kick-out rights through voting interests. Accordingly, the limited partnership would be considered a VIE.

>>>> Case B: Two Equal-Interest Limited Partners

55-4P Consider the same facts as in Case A, except that there are two limited partners that each hold an equal amount of the limited partnership's kick-out rights through voting interests. In this Case, a simple majority of the limited partnership's kick-out rights through voting interests would require a vote of both limited partners. Presuming the kick-out rights are substantive, a limited partnership entitling any individual limited partner to remove the general partner or a limited partnership that requires a vote of both limited partners to remove the general partner would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership's economic performance. Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity.

>>>> Case C: One Hundred Equal-Interest Limited Partners

55-4Q Consider the same facts as in Case A, except that there are 100 limited partners that each hold an equal amount of the limited partnership's kick-out rights through voting interests. In this Case, a simple majority of the limited partnership's kick-out rights through voting interests would require a vote of 51 limited partners. Presuming the kick-out rights are substantive, a limited partnership that requires a vote of less than 52 limited partners to remove the general partner would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership's economic performance. Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity. However, if a vote of 52 or more limited partners is required to remove the general partner and the limited partners do not possess substantive participating rights, that limited partnership would meet the condition in paragraph 810-10-15-14(b)(1)(ii) because the required vote is more than a simple majority of the limited partnership's kick-out rights through voting interests. Accordingly, the limited partnership would be considered a VIE.

>>>> Case D: Required Limited Partner Voting Percentages of More Than a Simple Majority

55-4R In this Case, consider the following situations based on a limited partnership agreement that requires a vote of 66.6 percent of the limited partnership's kick-out rights through voting interests to remove the general partner:

a. Equal-interest limited partners (Case D1)
b. Limited partners with unequal interests (Case D2).

>>>>> Case D1: Equal-Interest Limited Partners

55-4S There are 3 independent limited partners (none of which have any relationship to the general partner) that each hold an equal percentage (33.33 percent) of the limited partnership's kick-out rights through voting interests. A vote of 2 of the 3 limited partners represents 66.7 percent of the limited partnership's kick-out rights through voting interests, which also represents the smallest possible combination that is at least a simple majority of the limited partnership's kick-out rights through voting interests. Presuming the kick-out rights are substantive, the limited partnership would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership's economic performance. Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity.

>>>>> Case D2: Limited Partners with Unequal Interests

55-4T There are 3 independent limited partners (none of which have any relationship to the general partner) that hold 45 percent (Limited Partner 1), 25 percent (Limited Partner 2), and 30 percent (Limited Partner 3) of the limited partnership's kick-out rights through voting interests respectively. To remove the general partners, a vote of Limited Partner 1 in combination with either Limited Partner 2 or Limited Partner 3 would be a simple majority of the limited partnership's kick-out rights through voting interests and would satisfy the 66.6 percent contractual requirement. In contrast, a vote to exercise the kick-out right by Limited Partner 2 and Limited Partner 3 also would represent a simple majority of the limited partnership's kick-out rights through voting interests; however, their kick-out rights (55 percent) would not meet the required threshold of 66.6 percent to remove the general partners. Accordingly, assuming the limited partners do not possess substantive participating rights, the limited partnership would meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership's economic performance because the smallest possible combination (Limited Partner 2 and Limited Partner 3) that represents at least a simple majority of the limited partnership's kick-out rights through voting interests cannot remove the general partners. Accordingly, the limited partnership would be considered a VIE.

>>>> Case E: Four Equal-Interest Limited Partners with a Required Unanimous Vote of the Limited Partnership's Kick-Out Rights through Voting Interests

55-4U Assume that there are 4 independent limited partners (none of which have any relationship to the general partner) that each own 10 percent of the equity of the limited partnership in the form of limited partnership voting interests. The general partner owns 60 percent of the equity of the limited partnership and does not have kick-out rights through voting interests. The limited partners have kick-out rights through voting interests, but the limited partners must vote unanimously to kick out the general partner. Assuming the limited partners do not possess substantive participating rights, the limited partnership would meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership's economic performance because more than a simple majority of kick-out rights through voting interests is required to remove the general partner. Accordingly, the limited partnership would be considered a VIE.

>>>> Case F: Limited Partner and General Partner with a Required Simple Majority Percentage of the Limited Partnership's Kick-Out Rights through Voting Interests—Limited Partner Consolidates

55-4V Assume that there is an independent limited partner (who does not have any relationship with the general partner) that holds 40 percent of the equity of the limited partnership in the form of limited partnership voting interests. The general partner owns 60 percent of the equity of the limited partnership and does not have kick-out rights through voting interests. The limited partner has kick-out rights through voting interests, and a vote of a simple majority of the kick-out rights through voting interests to remove the general partner is required. Therefore, presuming the kick-out rights are substantive, the limited partnership would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership's economic performance because the single limited partner is able to exercise the kick-out rights unilaterally. Assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity. Accordingly, the limited partner that holds 40 percent of the equity of the limited partnership in the form of limited partnership voting interests would be deemed to have a controlling financial interest in the limited partnership on the basis of the guidance in paragraph 810-10-25-1A.

>>>> Case G: Four Equal-Interest Limited Partners with a Required Simple Majority Percentage of the Limited Partnership's Kick-Out Rights through Voting Interests—No Partner Consolidates

55-4W Assume that there are 4 independent limited partners that each own 10 percent of the equity of the limited partnership in the form of limited partnership voting interests. The general partner owns 60 percent of the equity of the limited partnership and does not have kick-out rights through voting interests. The limited partners have kick-out rights through voting interests, and a vote of a simple majority of the kick-out rights through voting interests to remove the general partner is required. Therefore, presuming the kick-out rights are substantive, the limited partnership would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership's economic performance. Assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity. Accordingly, no partner would be deemed to have a controlling financial interest in the limited partnership on the basis of the guidance in paragraph 810-10-25-1A because no single limited partner owns a majority of the limited partnership's kick-out rights through voting interests. Therefore, no partner consolidates the limited partnership.

4.5 Third VIE characteristic: Limited obligation to absorb expected losses

Excerpt from ASC 810-10

Variable Interest Entities

> Entities

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase *by design* refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.)

a. …
b. As a group the holders of the equity investment at risk lack any one of the following three characteristics:
   1. …
   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.

The third characteristic of a VIE is that the equity-at-risk group is not exposed to the legal entity's economic risks – i.e. expected losses (see chapter 10) – in the same way that a true residual interest is exposed to the entity's economic risks. For a legal entity not to be a VIE, its equity-at-risk group must bear the exposure to the first dollar risk of loss in the entity; sharing that exposure with non-equity investors is not permitted. If the equity-at-risk group is directly or indirectly protected from incurring any amount of the legal entity's expected losses either by the legal entity itself or by other parties involved with the entity, the entity is a VIE. [810-10-15-14(b)(2)]

Question 4.5.10
How does an enterprise assess whether equity-at-risk investors are shielded from expected losses?

Interpretive response: When evaluating whether the equity-at-risk group is shielded from expected losses, an enterprise should determine whether the equity investors would absorb the first dollar of loss. This is generally the case if, based on the contractual attribution of cash flows to the legal entity's various interest holders, there are no interests that:

— are subordinate to the equity at risk;
— protect equity investors; or
— guarantee the value of a legal entity's assets or the investors a return.

In some situations, there are arrangements that protect the equity-at-risk group from losses on specific assets held by the legal entity. An interest in a specific asset (or assets) of a legal entity is not a variable interest in the legal entity itself if the fair value of that asset is 50% or less of fair value of the legal entity's total assets (see section 3.6). Such an interest is referred to as an 'interest in specified assets' and its related expected losses are not included when determining the legal entity's expected losses. As a result, interests in specified assets do not shield the equity-at-risk group from absorbing the legal entity's expected losses. Conversely, if an interest in a specific asset (or assets) of a legal entity is a variable interest in the legal entity itself, that interest generally would shield the equity-at-risk group from absorbing the legal entity's expected losses. [810-10-25-55]

An enterprise would not generally need to perform a quantitative assessment to determine if the equity-at-risk group is shielded from expected losses. Evaluating these qualitative factors generally will be conclusive. See additional discussion in Questions 4.5.20 and 4.5.30, and Examples 4.5.10 to 4.5.30.

Question 4.5.20#

What types of arrangements may protect equity participants from a first dollar risk of loss?

Interpretive response: Common arrangements that may protect the equity-at-risk group from the first dollar risk of loss include the following (not exhaustive):

— a residual value guarantee of a legal entity's assets that comprise more than 50% of the fair value of the entity's total assets;

— an agreement to purchase an entity's specified assets that comprise more than 50% of the fair value of the entity's total assets;

— an arrangement that allocates a legal entity's cash flows in a manner that protects equity investors from the risk of loss – e.g. the governing documents of the legal entity include liquidation preferences that provide the equity holders priority in cash distributions over other interest holders;

— a credit enhancement for assets of the legal entity;

— a guarantee of a legal entity's debt (if equity investors are shielded from losses); and

— a reimbursement to the legal entity or its equity investors for losses.

A contractual arrangement to purchase the majority of a legal entity's goods or services on a cost-plus basis (e.g. actual costs plus a profit margin) may also protect the equity-at-risk group from the first dollar risk of loss. For example, if the cost of purchasing the goods or services exceeds their fair values, the purchaser may be providing the legal entity with a form of subordinated financial support.

Off-market contracts to sell or purchase goods or services may also protect the equity-at-risk group from first dollar risk of loss when the off-market pricing absorbs losses. To make this determination, consider the design of the legal entity and whether the off-market pricing absorbs losses the legal entity was designed to create.

Example 4.5.10

Residual value guarantee of assets comprising more than 50% of fair value of total assets

Background

Lessor issues $3,000 of equity and $97,000 of nonrecourse debt and uses the proceeds to purchase equipment with a fair value of $100,000. To protect against unexpected declines in the value of the equipment, Lessee is required to provide a residual value guarantee that the value of the equipment will be at least $80,000 at the end of the five-year lease term. At the end of the lease term, the unamortized balance on the nonrecourse debt is expected to be $78,000.

Evaluation

The equity-at-risk group is not obligated to absorb the expected losses of Lessor because it is protected by the residual value guarantee and the unamortized amount of the nonrecourse debt. Therefore, Lessor is a VIE because it possesses the third VIE characteristic: lack of obligation to absorb expected losses.

The equity-at-risk group cannot lose more than $1,000 (combined unamortized nonrecourse debt balance and equity ($81,000) less the amount of the residual value guarantee ($80,000) of its investment unless Lessee fails to honor the guarantee.

Note: Guarantees that protect Lessor's creditors do not cause Lessor to be a VIE if the guarantees do not also protect the equity-at-risk group from incurring a loss of its total investment.

In this example, if Lessee's residual value guarantee is at least $78,000, up to a maximum exposure of $50,000 – i.e. the residual value between $28,000 and $78,000 is guaranteed – the guarantee would not protect the equity-at-risk group from expected losses. In that scenario, the residual value guarantee would not cause Lessor to be a VIE.

Example 4.5.20

Lessee written put options on more than 50% of fair value of total assets

Background

Lessor, a legal entity, leases a tract of farmland worth $100 million to Lessee for seven years. Lessor finances its acquisition of the farmland by issuing $75 million of debt and $25 million of equity, all of which is considered at risk.

The equity-at-risk investors have control over significant decisions and are not constrained from selling their interests.

Scenario 1: Lessee writes a put option with strike price greater than debt

Lessee writes a put option that permits Lessor to sell the farmland to Lessee at the conclusion of the lease for 95% of the farmland's fair value at inception ($95 million).

Evaluation

Because the put option limits the losses that will be absorbed by the equity-at-risk group to $5 million ($100 million purchase price less the $95 million fair value guarantee provided by the put option), Lessor is a VIE because it possess the third VIE characteristic: lack of obligation to absorb expected losses.

Scenario 2: Lessee guarantees amount less than the debt

Lessee guarantees that the farmland will be worth $5 million at the end of the lease (5% of the fair value upon inception).

Evaluation

The equity-at-risk group is not shielded from expected losses. It would suffer a total loss of its investment if the fair value declined by $25 million at the end of the lease.

The guarantee protects only the debt holders from realizing a total loss, because they will be able to recoup $5 million from Lessee under the guarantee if the farmland is deemed to be worthless. As a result, Lessor is a not VIE because the equity-at-risk group has an obligation to absorb expected losses.

Scenario 3: Lessee writes a put option with strike price less than the debt

Lessee writes a put option allowing the debt holders to sell the farmland to it for $50 million in the event of foreclosure.

Evaluation

Consistent with Scenario 2, only the debt holders are shielded from losses. Because the put option becomes exercisable only on foreclosure – after the equity-at-risk investments are deemed to be worthless – the equity-at-risk group is not shielded from expected losses. As a result, Lessor is a not VIE because the equity-at-risk group has an obligation to absorb expected losses.

Example 4.5.30

Residual value guarantee of assets comprising less than 50% of fair value of total assets

Background

Partnership is formed to purchase and manage two industrial warehouses. It is capitalized by debt of $80 million and equity of $20 million. All equity is considered at risk.

After it is formed, Partnership acquires two buildings: Warehouse 1 for $55 million, and Warehouse 2 for $45 million.

Scenario 1: Lessee guarantees residual for less than 50% of fair value of the total assets

The tenant of Warehouse 2 guarantees that the residual value of the property will be worth at least $45 million at the end of its 10-year lease.

Evaluation

The residual value guarantee shields Partnership's equity investors from potential losses on Warehouse 2. However, the guarantee does not represent a variable interest in Partnership because the fair value of Warehouse 2 is less than 50% of the fair value of Partnership's total assets – i.e. the residual value guarantee is an interest in specified assets (see section 3.6).

Because the guarantee does not represent a variable interest in Partnership, it is not considered when evaluating whether the equity-at-risk group is obliged to absorb Partnership's expected losses (see Question 4.5.10). Therefore, the guarantee does not trigger the third VIE characteristic.

Scenario 2: Lessee guarantees residual for greater than 50% of fair value of the total assets

The tenant of Warehouse 1 guarantees that the residual value of the property will be worth at least $55 million at the end of its 10-year lease.

Evaluation

The guarantee represents a variable interest in Partnership because the fair value of Warehouse 1 is greater than 50% of the fair value of Partnership's total assets (see section 3.6). As a result, the residual value guarantee shields the equity-at-risk group from expected losses and triggers the third VIE characteristic, making Partnership a VIE.

Example 4.5.40

Expected losses absorbed by cost-plus contractual arrangement

Background

A group of US investors purchases 100% of the outstanding common shares of Airline from Seller for $60 million. Seller is a public company in Foreign Country. The transaction is necessary because Airline becomes licensed to fly in the

United States, and foreign investors are not eligible to own a majority ownership interest in an airline operating in the United States.

In connection with the acquisition, Airline enters into an 11-year agreement to provide aircraft, maintenance and insurance (ACMI) services to Seller. Airline's compensation under the ACMI agreement is cost plus 7% with a guaranteed minimum annual payment of $15 million. Total compensation is $165 million over 11 years.

The ACMI agreement results in Seller paying Airline more than 90% of Airline’s current and anticipated revenue. Economically, Seller has outsourced its US-air logistic activities to a third party eligible to be an investor in a US airline.

Seller has a variable interest in Airline through the ACMI agreement.

Evaluation

Airline is a VIE because its equity-at-risk group is not obligated to absorb expected losses. Seller reimburses all costs plus 7% and pays $15 million annually over 11 years. Through the ACMI arrangement, Seller absorbs a significant portion of Airline’s expected losses that would otherwise be absorbed by the equity-at-risk group.

Example 4.5.45**

Expected losses absorbed by an off-market contractual arrangement

Background

Investor1, a service company, and Investor2, a retailer, form a new legal entity (the Venture). Investor1 contributes a business with a fair value of approximately $10 million and $50 million of cash and Investor2 contributes $40 million of cash.

Upon creation, the Venture issues a single class of common stock. Investor1 and Investor2 hold 60% and 40%, respectively, of the Venture’s newly issued common stock (equity investment). Investor1 and Investor2 do not hold any other interests in the Venture and no other contractual or ownership/investment relationships exist between the parties.

Upon the Venture’s creation, Investor2 enters into a supply arrangement to provide substantially all of the inventory to the Venture at cost. The price is below what Investor2 would sell to third party customers. In addition, pricing is below market from the Venture’s perspective given Investor2’s comparatively established supply chain leverage and buyer-power. Therefore, the supply arrangement is off-market.

Evaluation

The off-market supply arrangement is a variable interest because it is designed such that Investor2 absorbs price risk of the Venture and effectively provides financing to the Venture. Investor2 absorbs expected losses greater than its 40% equity interest because the inventory sold to the Venture is below market value, which if sold at market value would otherwise manifest as larger expected losses (see Question 4.5.30).

Even though the supply arrangement is with an equity-at-risk holder (Investor2), the supply arrangement is a separate variable interest and not part of the equity investment at risk that protects the equity-at-risk group from the first dollar risk of loss related to inventory risk. Therefore, the Venture is a VIE because its equity-at-risk group is protected from first dollar risk of loss.

Question 4.5.30

How does an equity investor's exposure to expected losses through a non-equity variable interest affect the third VIE characteristic?

Interpretive response: An enterprise does not consider the exposure of non-equity at risk variable interests to expected losses in determining whether the legal entity's equity-at-risk group is obliged to absorb the entity's expected losses. This is the case even if the other variable interests are held or issued by an investor in the equity-at-risk group.

When expected losses are shared between non-equity holders and the equity-at-risk group, the legal entity is a VIE. This is because the equity-at-risk group cannot, by design, be shielded from the risk of loss on any portion of its investment by the entity itself, or by others that are involved with the entity. When parties other than the equity-at-risk group are exposed to the legal entity's expected losses, voting interests become less relevant in identifying the parties that may have control over the entity's activities.

Exception for interests in specified assets

Guarantees or other arrangements that pertain to specific assets of a legal entity are not deemed to protect the equity-at-risk group from absorbing the entity's expected losses as long as the specified assets represent less than 50% of the fair value of the legal entity's total assets (see Question 4.5.10). Therefore, an equity investor will not trigger the third VIE characteristic by guaranteeing specific assets that represent less than 50% of the fair value of the legal entity's total assets.

Conversely, guaranteeing specific assets that represent greater than 50% of the fair value of the legal entity's total assets generally would protect the equity-at-risk group from absorbing the entity's expected losses.

Example 4.5.50

Expected losses absorbed by non-equity interests

Background

Investor1, Investor2 and Investor3 form a venture (Legal Entity) by each contributing $1,000 at inception in exchange for equity interests. All equity contributed is considered at risk.

Legal Entity uses its capital to purchase a fixed income investment grade bond for $1,700.

Scenario 1: Freestanding guarantee issued by equity-at-risk holder

In exchange for a $250 premium, Investor 3 agrees to guarantee that the value of the bond will be at least $1,700 if it is sold within the next five years, which is Legal Entity's maximum life.

Evaluation

Legal Entity is a VIE because its expected losses are absorbed by a non-equity-at-risk interest (the guarantee). This is the case even though the non-equity-at-risk interest is held by a member of the equity-at-risk group.

Scenario 2: Freestanding TRS issued by non-equity-at-risk holder

Legal Entity enters into a TRS with a bank whereby the venture will pay 80% of the total return on the fixed-rate bond in exchange for a LIBOR indexed return.

Evaluation

The equity-at-risk investors are shielded from 80% of any losses on the fixed-rate bond – e.g. if the value of the bond declines by $1, the bank would absorb $0.80 and the equity investors would absorb $0.20 of the losses. The arrangement would result in the bank shielding the equity investors from $0.80 of the first dollar risk of loss. Therefore, Legal Entity is a VIE because it meets the third VIE characteristic – lack of obligation to absorb expected losses.

Question 4.5.40

Can the third VIE characteristic be triggered by a customary business arrangement that protects from risk of loss?

Interpretive response: The third VIE characteristic was developed to identify structures:

— designed to protect the equity-at-risk group from losses resulting from the risks the legal entity was designed to create and distribute to its variable interest holders; or

— in which the equity investments lack economic substance.

Certain routine business arrangements (e.g. property and casualty or business interruption insurance) shield the equity-at-risk group from some of a legal entity's losses. However, we do not believe this, by design, triggers the third VIE characteristic. An enterprise must exercise judgment when determining whether, by design, the equity-at-risk group is being shielded from the expected losses that the VIE was designed to create and distribute to its variable interest holders (see section 3.3).

Derivatives transferring all or substantially all of an entity's variability to the counterparty are generally not considered customary.

Example 4.5.60
Customary business arrangement protects from loss

Background

Legal Entity is a publicly traded soybean farmer and distributor. For risk management purposes, Legal Entity purchases property and casualty insurance and business interruption insurance. In addition, Legal Entity enters into fixed-price forward contracts with buyers for 45% of its expected crop output to protect against declining soybean prices.

Evaluation

Legal Entity is not a VIE merely because it implements risk management programs designed to protect against potential losses.

As stated in Question 4.5.40, we believe the third VIE characteristic is intended to identify entities that, by design, protect the equity-at-risk group from losses that the legal entity was designed to create and distribute to its equity interest holders.

In this example, Legal Entity likely was designed to create and distribute to its variable interest holders credit risk, price risk and operations risk. We do not believe Legal Entity possesses the third VIE characteristic because:

— the forward contracts are creators of variability (and therefore do not absorb variability); and
— the insurance policies absorb losses other than those that Legal Entity was designed to create and distribute to its variable interest holders.

Question 4.5.50
Is the third VIE characteristic triggered if equity-at-risk investors share losses disproportionately to their ownership percentages?

Interpretive response: No. Equity-at-risk investors may agree to share losses disproportionately to their respective ownership percentages (e.g. through allocation agreements) without triggering the third VIE characteristic. This is because that characteristic is applied to the equity-at-risk equity group as a whole. [810-10-15-14(b)(2)]

Example 4.5.70
Disproportionate allocation of losses

Background

Partnership's General Partner is responsible for managing all of Partnership's real estate activities. General Partner's interest is considered equity at risk.

The LPs contribute capital, also considered at risk. LPs share in the profits and losses based on their ownership percentages and have simple majority substantive participating rights.

Partnership's equity at risk is considered sufficient under the first VIE characteristic (see section 4.3).

General Partner is responsible for Partnership's debts, but LPs cannot incur liabilities in excess of their capital contributions.

Evaluation

The expected losses are disproportionately allocated to General Partner. However, the third VIE characteristic is not triggered because it is applied to the equity-at-risk investors as a group.

However, the fifth VIE characteristic about disproportionality (see section 4.7) must also be evaluated before concluding that Partnership is not a VIE.

4.6 Fourth VIE characteristic: Capped right to receive residual returns

Excerpt from ASC 810-10

Variable Interest Entities

> Entities

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase *by design* refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.) …

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

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

The fourth characteristic of a VIE is that the equity-at-risk group does not have the right to receive the legal entity's economic rewards in the same way that a true residual interest has the right to receive the economic rewards of an entity. This characteristic is triggered when an equity-at-risk group's right to receive the legal entity's expected residual returns (see chapter 10) is capped in one of two ways: [810-10-15-14(b)(3)]

— by the entity's governing documents; or
— through arrangements with the entity or other variable interest holders outside the equity-at-risk group.

The right to receive expected residual returns embodied in a variable interest other than an equity-at-risk investment cannot be considered when determining whether the entity's equity-at-risk group has the right to receive the entity's expected residual returns. [810-10-15-14(b)(3)]

Question 4.6.10

Is the fourth VIE characteristic triggered if the equity-at-risk group does not receive all of the expected residual returns?

Interpretive response: Not necessarily. Other variable interest holders may share in a portion of the expected residual returns if the sharing arrangement does not cap, explicitly or implicitly, the equity-at-risk group's returns.

Example 4.6.10

Sharing of returns between equity-at-risk group and variable interest holders

Background

Three investors form Partnership to acquire a commercial property for investment purposes. Each investor owns one-third of the outstanding equity interests, all of which are considered at risk.

Partnership acquires a commercial office property with the funds received at formation. Because the investors are not familiar with the property management business, they hire Property Manager to identify tenants, negotiate and set leasing terms, and maintain the property.

Property Manager receives an annual fee of $100,000 and 25% of all partnership returns once it has achieved a 10% internal rate of return (IRR).

Evaluation

The fourth VIE characteristic is not triggered by Property Manager's right to some Partnership returns because the returns of the equity-at-risk group are not capped – i.e. the equity-at-risk investors will receive 75% of all returns after a 10% IRR has been achieved.

Question 4.6.20

How is the cap on the right to receive expected residual returns applied?

Interpretive response: Essentially, an enterprise needs to distinguish between arrangements that:

— cause the equity-at-risk group's right to receive the legal entity's expected residual returns to be capped; versus
— simply result in the equity-at-risk investors receiving less than 100% of the expected residual returns.

Making this determination can be difficult because Subtopic 810-10 provides very little guidance about the meaning of 'capped'.

Subtopic 810-10 does indicate that the equity-at-risk group's right to receive expected residual returns is not considered to be capped by outstanding stock options, convertible debt or similar interests in the legal entity. If the options in those instruments are exercised, the holders simply become additional equity investors in the legal entity. [810-10-15-14(b)(3)]

Similarly, we believe the equity-at-risk group's right to receive expected residual returns is generally not capped in the following circumstances:

— an equity-at-risk investor writes a fixed-price call option for another party (or parties) to acquire some or all of the investor's equity interest; or
— the legal entity writes a fixed-price call option on some, but not all, of the legal entity's assets.

In contrast, predetermined distribution arrangements that cap the residual returns allocated to the equity-at-risk group to a de minimis amount may result in triggering the fourth VIE characteristic, which would result in the legal entity being a VIE.

Example 4.6.20

Cap on right to receive expected residual returns

Background

Legal Entity owns two manufacturing machines: Machine A with an initial fair value of $75, and Machine B with an initial fair value of $25.

Legal Entity leases both machines to lessees under operating leases. At the end of Machine A's lease term, the lessee has the right to exercise a purchase option to buy the machine for a fixed price of $50. Because the fair value of Machine A is greater than 50% of the fair value of the lessor's total assets, the lessee's purchase option on Machine A is considered a variable interest in Legal Entity and must be considered in evaluating the five VIE characteristics (see section 3.6).

Evaluation

This purchase option limits the equity-at-risk group's right to receive the expected residual returns. If the value of Machine A is greater than $50 at the end of the lease term, the lessee would be able to benefit from the excess of the then-fair value over the fixed purchase price of $50.

However, the equity-at-risk group's right to receive the expected residual returns is not capped because there is no fixed-price purchase option provided to the lessee of Machine B. As a result, the purchase option does not trigger the fourth VIE characteristic.

Example 4.6.30
Expected residual returns received by non-equity interests

Background

Investor1, Investor2 and Investor3 form Investment Partnership and each contribute $1,000 at inception in exchange for equity interests. All equity contributed is considered at risk.

Investment Partnership uses its capital to purchase a fixed income investment grade bond for $3,000; it will not purchase any other investments.

Investment Partnership also writes a call option that allows Investor2 to purchase the fixed income investment grade bond for $3,500 after three years.

Evaluation

All returns generated by Investment Partnership will be received by the equity-at-risk group. However, the returns received by the equity investors through their at-risk equity investments are capped by the call option held by Investor2. Because the call option is not an at-risk equity investment, it triggers the fourth VIE characteristic. Therefore, Investment Partnership is a VIE.

Question 4.6.30
Can a qualitative assessment be made to determine whether the fourth VIE characteristic applies?

Interpretive response: Similar to evaluating whether the equity-at-risk group is obliged to absorb expected losses (see Question 4.5.10), a qualitative assessment is often sufficient for determining whether the equity-at-risk group has the right to receive the expected residual returns.

This evaluation generally entails understanding the attribution of cash flows to the legal entity's various interest holders, including whether certain variable interest holders share in the legal entity's cash flows to such an extent that the arrangement results in a capped return to the equity-at-risk group.

Example 4.6.40
Qualitative assessment of right to receive expected residual returns

Scenario 1: Lessee with a fixed-price purchase option

Legal Entity leases a tract of farmland worth $100 million to Lessee for seven years. Legal Entity finances its acquisition of the farmland by issuing $75 million of debt and $25 million of equity, all of which is considered at risk.

The equity investors have control over decision-making and are not constrained from selling their interests. Further, Lessee has the option to purchase the farmland at a fixed price ($100 million) at the end of the lease term.

Evaluation

By design, the fixed-price purchase option caps the expected residual returns of the equity-at-risk group. Therefore, the option triggers the fourth VIE characteristic, and Legal Entity is a VIE.

Scenario 2: Employee profit-sharing plan

Legal Entity is a publicly traded hospital network in the Northeast. To attract the most qualified doctors, Legal Entity has an employee profit-sharing plan that provides its employees up to 5% of its annual net income.

Evaluation

Although Legal Entity's profits are shared with non-equity investors under the terms of the employee profit-sharing program, this arrangement does not cap the returns of the equity-at-risk group. Therefore, this arrangement does not trigger the fourth VIE characteristic.

Scenario 3: Incentive fee with profit-sharing

Three investors form Investment Partnership by each contributing $1,000 at inception in exchange for equity interests. All equity contributed is considered at risk.

Investment Partnership hires Investment Advisor to make all decisions about the purchases and sales of its investments. For its services, Investment Advisor receives a fixed fee of $100 each month and all of Investment Partnership's monthly profits over $10,000.

Evaluation

Because the fee arrangement caps the equity-at-risk group's returns to $10,000 per month, it triggers the fourth VIE characteristic. Therefore, Investment Partnership is a VIE.

Question 4.6.40
Is the fourth VIE characteristic triggered if equity-at-risk investors share residual returns disproportionately to their ownership percentages?

Interpretive response: No, because the fourth VIE characteristic is applied to the equity-at-risk group as a whole. Therefore, equity-at-risk investors may agree to share the legal entity's residual returns disproportionately to their ownership percentages (e.g. through allocation agreements) without triggering the fourth VIE characteristic.

Example 4.6.50
Sharing of returns among equity-at-risk investors disproportionately to ownership percentages

Background

Stone Co. (Stone) and Mineral Co. (Mineral) form Legal Entity to mine and sell precious stones and minerals. At formation, Stone contributes proven stone producing mines while Mineral contributes unproven, but potentially fertile mineral producing land.

Because Stone has given up proven property, the partners have agreed to allocate the profits as follows:

- Stone will receive all profits until a cumulative 8% return has been reached;
- Mineral will then receive all profits until a cumulative 15% return has been reached;
- All profits in excess of a 15% cumulative return will be allocated to Stone.

Evaluation

Although this profit allocation arrangement caps Mineral's returns, Stone's returns are not capped. Because all of Legal Entity's returns are allocated the equity-at-risk investors as a group, the profit allocation arrangement does not trigger the fourth VIE characteristic.

Question 4.6.50
Is the fourth VIE characteristic triggered if expected residual returns on any assets are capped?

Interpretive response: Not necessarily. We believe a cap on the return of a specified asset (or assets) does not result in the equity-at-risk group lacking the right to receive expected residual returns. The exception is when the returns are capped on substantially all of a legal entity's assets through a variable interest in the legal entity. An interest is a variable interest in the legal entity (versus an interest in specified assets) only when it relates to assets comprising more than 50% of the fair value of the entity's total assets (see section 3.6).

Example 4.6.60
Disproportionate sharing of returns within the equity-at-risk group

Background

Partnership, a real estate venture, is formed to purchase and manage two industrial warehouses. Partnership is capitalized by debt of $80 million and equity of $20 million. All equity is considered at risk.

Partnership acquires Warehouse 1 for $55 million and Warehouse 2 for $45 million.

The tenant of Warehouse 1 has the option to purchase the property for $55 million at the end of its 10-year lease.

Evaluation

The fixed-price purchase option held by the tenant of Warehouse 1 is a variable interest in Partnership. This variable interest caps the returns of Partnership's equity-at-risk group with respect to Warehouse 1. However, it does not cap the equity-at-risk group's right to receive Partnership's expected residual returns because the returns from Warehouse 2 are not capped. Therefore, the fixed-price purchase option does not trigger the fourth VIE characteristic.

Note: If the tenant of Warehouse 2 also held an option to purchase Warehouse 2 for $45 million upon conclusion of its lease, we believe the returns on substantially all of Partnership's assets would be capped. Therefore, the fourth VIE characteristic would be triggered even though the purchase option on Warehouse 2 would not represent a variable interest in Partnership as a whole.

4.7 Fifth VIE characteristic: Disproportionality

Excerpt from ASC 810-10

Variable Interest Entities

> Entities

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase *by design* refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.) …

c. The equity investors as a group also are considered to lack the characteristic in (b)(1) if both of the following conditions are present:
   1. The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their

rights to receive the expected residual returns of the legal entity, or both.

2. Substantially all of the legal entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. This provision is necessary to prevent a **primary beneficiary** from avoiding consolidation of a VIE by organizing the legal entity with nonsubstantive voting interests. Activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights shall be treated as if they involve or are conducted on behalf of that investor. The term *related parties* in this paragraph refers to all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d).

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

> Consolidation Based on Variable Interests

>> The Effect of Related Parties

25-43 For purposes of applying the guidance in the Variable Interest Entities Subsections, unless otherwise specified, the term *related parties* includes those parties identified in Topic 850 and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder. All of the following are considered to be de facto agents of a reporting entity:

a. A party that cannot finance its operations without **subordinated financial support** from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary
b. A party that received its interests as a contribution or a loan from the reporting entity
c. An officer, employee, or member of the governing board of the reporting entity
d. A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party’s ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.
    1. Subparagraph superseded by Accounting Standards Update No. 2009-17
    2. Subparagraph superseded by Accounting Standards Update No. 2009-17
e. A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.

Excerpt from ASC 850-10

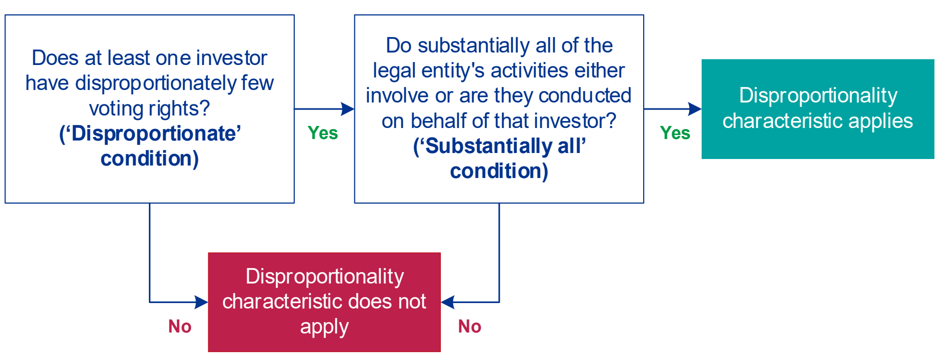
20 Glossary

Related Parties – Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Subtopic 810-10 has an anti-abuse provision (the 'disproportionality provision') that if applicable negates a conclusion that a legal entity's equity-at-risk group has the power to direct the legal entity's most significant activities. Therefore, if the disproportionality provision applies, a legal entity is a VIE because the equity-at-risk group is deemed to lack the power to direct the entity's most significant activities. However, because the disproportionality provision is generally evaluated separately, we refer to it in this Handbook as the fifth VIE characteristic – disproportionality.

The fifth VIE characteristic applies if substantially all of a legal entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights. Applying the provision is a two-step process, as follows. [810-10-15-14(c)]



Question 4.7.10
What is the purpose of the disproportionality characteristic?

Interpretive response: The disproportionality characteristic is an abuse prevention mechanism designed to ensure that an enterprise that would otherwise be required to consolidate a VIE cannot avoid that requirement by organizing the entity with nonsubstantive voting interests.

The SEC staff has commented on the disproportionality characteristic for determining whether an entity is a VIE. It believes that the intent of this characteristic is to move the consolidation analysis from the VOE consolidation model to the VIE consolidation model if it is clear that the investor with disproportionately few voting rights (as compared to its economic interest) derives substantially all of the benefits of the activities of the entity. In that case, the voting arrangements are not useful in identifying the party that controls the legal entity. [2003 AICPA Conf]

Although the disproportionality characteristic is intended to be an abuse prevention mechanism, in practice it can also capture circumstances that may not necessarily represent efforts to circumvent the VIE standard.

4.7.10 Applying the disproportionate condition

An investor has disproportionately few voting rights in a legal entity if its voting interests are disproportionately small relative to its exposure to the entity's expected losses, expected residual returns, or both. [810-10-15-14(c)(1)]

Question 4.7.20
Are only the obligations and rights embedded in an investor's equity relevant to whether the investor has disproportionally few voting rights?

Interpretive response: No. We understand the FASB intended a variable interest holder to consider all of its variable interests held in a legal entity when determining whether its voting rights are proportional to its exposure to the entity's variability.

Example 4.7.10
Investor also has other variable interests

Background

Investor owns a 5% equity interest in Partnership and provided it with $5 million of subordinated debt financing. In total, Investor's debt and equity positions in the partnership comprise approximately 75% of Partnership's total capitalization. Investor's voting rights are proportionate to its 5% equity interest.

Evaluation

Investor has disproportionately few voting rights in relation to its economic interest (including both debt and equity variable interests) because it has an economic position in Partnership that approximates 75% of its capital structure (debt and equity financing) but has only a 5% voting interest.

Question 4.7.30

Is the disproportionate condition present if there is any disproportionality between an investor's voting rights and variable interests?

Interpretive response: Yes. Any disproportionality between an investor's voting rights and its variable interests meets the disproportionate condition.

We believe that in most entities there is disproportionality between the equity-at-risk investors' voting rights and their variable interests, and therefore the disproportionate condition typically will be present. This is particularly the case when:

— all of a legal entity's variable interests are not held by the equity-at risk-investors on a pro rata basis – e.g. some, but not all, of the equity-at-risk investors hold debt of the entity; or

— the legal entity is a limited partnership or similar entity, such as a limited liability company with governing provisions that are the functional equivalent of a limited partnership (see Question 4.7.50).

Therefore, in most situations, we believe the substantially all condition (see section 4.7.20) needs to be analyzed.

Question 4.7.40

Are interests held by related parties considered when evaluating the disproportionate condition?

Interpretive response: No. The term 'investors' in this context refers to an individual investor and excludes related parties and de facto agents. Therefore, if two investors are related parties, their voting interests are not combined to determine whether one or both has disproportionately few voting rights. [810-10-15-14(c)(1)]

Question 4.7.50

How is the disproportionate condition applied to limited partnerships?

Interpretive response: Whether and how the disproportionate condition is applied to a limited partnership depends on whether at least one of the limited partners has substantive participating rights.

No substantive participating rights

In many limited partnership arrangements, the GP has 100% of the voting rights and possesses all decision-making rights while the LPs have no voting rights. In these situations, the second VIE characteristic is triggered (see section 4.4.30) and the limited partnership would already be considered a VIE. Therefore, there would be no need to determine whether the disproportionality characteristic applies.

Substantive participating rights

In other limited partnerships, an LP has substantive participating rights, meaning that the LP has the right to make the decisions about the activities that most significantly impact the legal entity's economic performance. In these situations, we believe the LP and the GP each have 50% of the voting interests for purposes of evaluating the proportionality of each investor’s voting rights.

Example 4.7.20

Disproportionate condition applied to limited partnership

Scenario 1: Economic interests limited to equity interests

Investor1 and Investor2 form Legal Entity, a real estate investment partnership. Investor1 contributes $75 and Investor2 contributes $25 in exchange for equity interests in Legal Entity.

The investors’ interest in Legal Entity are as follows.

	Economic interest	Voting interest
Investor1	75%	50%
Investor2	25%	50%

— The investors have equal voting interests because they must agree on decisions about all significant activities before any actions are taken, including the approval of the annual operating budget.

— Under the partnership agreement, profits and losses are allocated in direct proportion to each investor's economic interests.

Evaluation

There is disproportionality between the investors' voting rights and economic interests. The investors receive 75% and 25%, respectively, of Legal Entity's profits or losses, but each have 50% of the voting rights.

As a result, each investor must evaluate the substantially all condition to determine whether the fifth VIE characteristic applies and Legal Entity is a VIE.

Scenario 2: Economic interests including equity and debt interests

In addition to the facts in Scenario 1, Investor2 makes a subordinated loan to Legal Entity, which increases its exposure to expected losses to 55%.

Evaluation

There is disproportionality between the investors' voting rights and economic interests. The investors absorb 55% and 45%, respectively, of Legal Entity's expected losses, but each have 50% of the voting rights.

As a result, each investor must evaluate the substantially all condition to determine whether the fifth VIE characteristic applies and Legal Entity is a VIE.

4.7.20 Applying the substantially all condition

Once an enterprise determines that at least one investor has disproportionately few voting rights, it then determines whether substantially all of the legal entity's activities involve or are conducted on behalf of that investor. This guidance serves as an anti-abuse mechanism to identify cases where the voting arrangements are not an indication of the enterprise who truly has the power to direct the activities that most significantly impact the entity.

When substantially all of the entity's activities involve or are conducted on behalf of a variable interest holder with disproportionately few voting rights, that variable interest holder often has the power to direct the most significant activities of the VIE (see section 6.3). [810-10-15-14(c)(2)]

Question 4.7.60#

What factors are evaluated when applying the substantially all condition?

Interpretive response: Subtopic 810-10 does not provide guidance about the meaning of the phrase 'substantially all of the legal entity's activities'.

Evaluating this condition requires judgment about the nature of both the legal entity's and investor's activities. Because this is a facts and circumstances determination, we do not believe the presence of any one factor is determinative.

Although the amount of the entity's variability attributable to the investor with disproportionately few voting rights is an important factor to consider, we do not believe an evaluation of this condition should be primarily quantitative in nature. Instead, we believe this evaluation should also focus on qualitative factors, which may include:

- the nature of the entity's business and the investor's business;
- whether interests other than the investor's are widely dispersed;
- the rights and obligations of each variable interest holder and the role each variable interest holder has in the entity's operations; and
- the reasons the investor's voting rights are disproportionately less than its economic interest in the entity.

When economics are skewed heavily toward an investor with disproportionately few voting rights, this is a strong indicator that substantially all the legal entity's activities either involve or are conducted on behalf of the reporting entity. However, we do not believe the size of an investor’s investment is determinative.

Other factors to consider with respect to the investor with disproportionately few voting rights include the following (not exhaustive).

The nature and extent of decisions that the investor can make
Whether most of the legal entity's assets were acquired from the investor
The significance of the legal entity's operations to the investor compared with their significance to other variable interest holders
Whether the nature of the legal entity's operations is similar to those of the investor
The amount of the legal entity's products or services purchased from or sold to the investor (and whether the legal entity has the substantive ability to purchase from or sell to third parties)
Whether the legal entity's employees are the same as (or related to) those of the investor
Whether the investor outsourced activities to the legal entity or the legal entity was designed to perform activities previously performed by the investor
Whether the investor is required to fund losses incurred by the legal entity
The amount of the legal entity's assets that have been leased to or from the investor
Whether the investor (or the investor’s employees) is actively involved in the management of the legal entity’s operations
Whether the legal entity's employees are compensated based on the performance of the investor
Whether the investor has the right to purchase the legal entity's assets (e.g. fixed-price purchase options that are in the money, etc.)
Whether the legal entity can put (sell) assets to the investor
Whether other investors have the option to put their interests to the investor, or the investor has an option to call other investor’s interests
If a research and development entity, whether the investor has the right to obtain the results of the research or intangible assets resulting from the entity’s research activities.
The extent of the legal entity’s activities that involve providing loans or leases to customers of the investor

Example 4.7.30
Investor has supply contract with legal entity

Background

Enterprise (a food processor) and Bank (an investor) form Legal Entity to sell food wholesale. Legal Entity's legal agreements stipulate that Legal Entity may purchase only Enterprise's foods.

Enterprise has disproportionately few voting rights based on the parties' following interests in Legal Entity.

	Economic interest	Voting interest
Enterprise	75%	34%
Bank	25%	66%

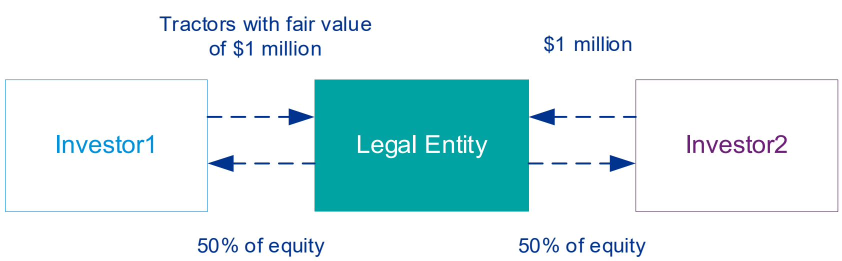
Evaluation

The disproportionality characteristic is present because substantially all of Legal Entity's activities (i.e. purchasing Enterprise's foods) are conducted on behalf of Enterprise, which has disproportionately few voting rights in relation to its economic interest in Legal Entity. Therefore, Legal Entity has the fifth VIE characteristic.

Example 4.7.40
Joint venture to distribute the product of one investor

Background

Investor1, a tractor manufacturer, establishes Partnership with Investor2 through the following transaction to purchase tractors and sell them to dealers in upstate New York.



Scenario 1: Joint decision-making with investor return based on a hurdle rate

All decisions relative to Partnership's operations must be jointly agreed to by the two investors. Profits and losses are shared equally (in direct proportion to ownership interests) until the investors achieve an internal rate of return of 10%. At which point Investor1 receives 75% of Partnership's profits.

Evaluation

Investor1's voting rights are disproportionately less than its exposure to Partnership's expected losses and expected residual returns. However, Partnership is not considered a VIE under the fifth VIE characteristic if substantially all of its activities are not conducted on Investor1's behalf.

Judgment and an evaluation of all facts and circumstances is required when determining whether substantially all of a legal entity's activities are conducted on behalf of an equity-at-risk investor with disproportionately few voting rights. For example, if Partnership will not acquire substantially all of the tractors to be sold to dealers from Investor1, substantially all of its activities may not be conducted on behalf of Investor1.

Scenario 2: Joint decision-making with investor as sole customer

Partnership is required to sell all tractors to Investor1-franchised dealerships.

Evaluation

Investor1's voting rights are disproportionately less than its exposure to Partnership's expected losses and expected residual returns. Because all of the tractors are sold to Investor1-franchised dealerships, substantially all of Partnership's activities either involve or are conducted on Investor1's behalf. Therefore, the fifth VIE characteristic is present and Partnership is a VIE.

Example 4.7.50
Passive investor has disproportionately few voting rights

Background

Legal Entity is formed to acquire and manage commercial office properties.

Investor1, a property manager, identifies the properties to be purchased, negotiates the purchase price, identifies prospective tenants, sets the lease terms and rental rates, collects rent from tenants, and maintains the properties. Investor1 owns a 1% equity interest in the venture, which meets the definition of equity at risk.

Investor2 is unrelated to Investor1 and owns the remaining 99% of the equity at risk. Investor2 is not engaged in the real estate business, has no decision-making rights, and is holding its interest as a passive real estate investment.

Evaluation

Because Investor2 has disproportionately few voting rights relative to its economic interest, Legal Entity is a VIE if substantially all of its activities are conducted on behalf of Investor2.

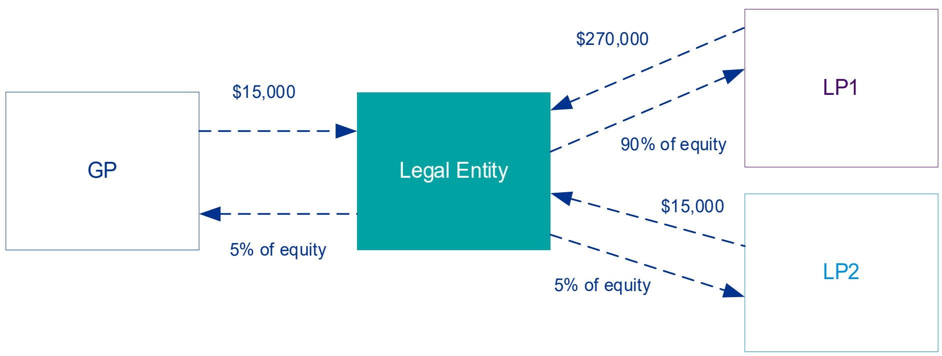
The size of Investor2's investment is a strong indicator that Legal Entity's activities are conducted on Investor2's behalf. However, the size of Investor2's investment is not determinative. Instead, the nature of Legal Entity's activities should be compared to those of Investor2 to assist in performing this evaluation.

In this example, Legal Entity is involved in acquiring and managing commercial real estate but Investor2 has no operations in the real estate business or ability to influence Legal Entity's operations. Therefore, despite the heavily skewed economics on behalf of Investor2, we believe that substantially all of Legal Entity's activities do not involve and are not conducted on behalf of Investor2. As such, the fifth VIE characteristic is not present.

Example 4.7.60
Real estate investment limited partnership

Background

Partnership, a single-purpose limited partnership, acquires a stabilized, leased commercial real estate asset for $1 million. It is formed with the following owners.



— In addition, there is senior debt financing totaling $700,000 that is nonrecourse to the partners or Partnership's other assets. Therefore, this debt represents 70% of Partnership's overall capitalization: $700,000 ÷ ($700,000 + $15,000 + $270,000 + $15,000). The partners' interests represent 30%.

— GP controls Partnership's daily activity within established parameters. LP1 has participating rights that equate generally to joint control on key decisions and therefore the second VIE characteristic is not triggered (see section 4.4.30).

— LP2 is the lessee of approximately 95% of the property's space and has protective rights only.

Cash waterfall

The following is the cash waterfall from the overall performance of the real estate.

(1) Payment to senior debt interest;

(2) Payment of GP management fees/expenses (fixed, not variable with performance);

(3) Payment of other expenses and capital improvements/repairs and maintenance;

(4) Repayment of senior debt principal;

(5) 9% annual preference return on investment to LPs;

(6) 9% annual preference return on investment to GP;

(7) Return of LPs capital;

(8) Return of GP capital; and

(9) 50/50 sharing of all remaining returns between GP and LPs.

Dissolution provision

The partnership agreement contains a dissolution provision if GP and LP1 cannot agree on significant actions. The dissolution provision requires that the party initiating the dissolution (either GP or LP1) offer to purchase the interest of the other party. The other party must either agree to sell or purchase at that price. Although GP has significantly less financial capability, it is a subject matter expert for the related real estate and market and has access to other potential LPs to refinance the partnership.

In the event of a dissolution, LP2 has a right of first refusal to purchase the interest being sold as a result of the dissolution for the price established on dissolution.

Evaluation

The partners' voting rights are disproportionate to their variable interests. Therefore, Partnership is a VIE if substantially all of its activities either involve or are conducted on behalf of one of the LPs whose voting rights are disproportionately few in relation to their economic interests (or a related party group that includes that LP; see Question 4.7.70).

The fact that the LP2 leases approximately 95% of the property's space indicates that substantially all of Partnership's activities are being conducted on behalf of LP2. Therefore, Partnership is a VIE because:

— the voting rights of some investors are disproportionate to their obligations to absorb the expected losses of the entity, to receive the expected residual returns of the entity, or both; and

— substantially all of the entity's activities either involve or are conducted on behalf of an investor (LP2) with disproportionately few voting rights.

Changing the facts

The answer likely would change under any of the following circumstances:

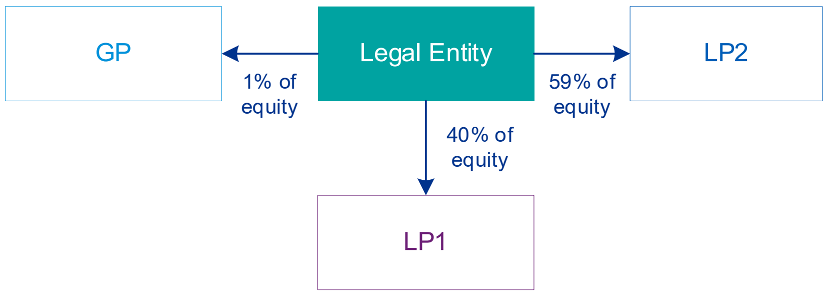
— LP2 holds $15,000 of the debt interests instead of an LP interest;
— LP2 holds neither a debt nor an LP interest – i.e. its only interest is as a lessee of the property; or
— LP2 is the lessee of only 50% of the property's space.

In the first two circumstances, the answer would change because the lessee would not be considered an investor when determining whether an equity investor has disproportionately few voting rights. In the third circumstance, the answer would change because the lessee's level of usage is not sufficient to indicate that substantially all of Partnership's activities are being conducted on its behalf.

Example 4.7.70
Real estate development limited partnership

Background

Partnership, a real estate development limited partnership, is formed with the following owners.



— LP1 is a real estate developer that sells Partnership 100% of the real estate that Partnership will develop. There are no debt interests in Partnership.

— GP controls Partnership's daily activities within established parameters. The LPs as a group have participating rights that generally equate to joint control with the GP on key decisions and therefore the second VIE characteristic is not triggered (see section 4.4.30).

— The partners participate in Partnership losses in proportion to their partnership interests. Partnership gains are shared in proportion to the partners' interests after payment of a preference return to GP, which is determined as a percentage of the appreciation in the value of the property.

Evaluation

Partnership is a VIE under the fifth VIE characteristic.

— **Disproportionate condition.** This condition is met because the voting interests of the partners are disproportionate to their economic interests. The GP's voting interest resulting from its operational control and the need for its approval on certain key decisions is disproportionately greater than its 1% economic interest. This means the voting interests of the LPs are disproportionately less than their collective 99% economic interest.

  Therefore, Partnership is a VIE if substantially all of its activities either involve or are conducted on behalf of an investor (and its related party group) with disproportionately few voting rights.

— **Substantially all condition.** This condition is met because substantially all of Partnership's activities are deemed to involve or be conducted on behalf of LP1. LP1 is a real estate developer that provides all of the real estate under development by Partnership – i.e. LP1 and Partnership appear to be in the same business with substantially similar activities.

Question 4.7.70

Are interests of related parties considered when applying the substantially all condition?

Interpretive response: Yes. The term 'investor' includes related parties when determining whether substantially all of a legal entity's activities either involve or are conducted on behalf of the investor with disproportionately few voting rights. [810-10-15-14(c)(2)]

In this context, 'investor' is defined as including:

— related parties identified in Topic 850; and
— certain de facto agents of the variable interest holder.

De facto agents of an investor are discussed in section 6.5.20. One type of de facto agent is a party that has an agreement that it cannot sell, transfer or encumber its interests without the prior approval of the investor. This type of de facto agent is not considered a related party of the investor under the substantially all condition (see Question 4.7.60). [810-10-25-43]

However, all other types of de facto agents are considered related parties in this context. This includes a party that has a close business relationship with the reporting enterprise like the relationship between a professional service provider and one of its significant clients. The SEC staff has commented on how to determine whether close business associates are de facto agents for purposes of the disproportionality characteristic. The staff believes that the close business associates are only considered related parties if one party can control or significantly influence the other party to an extent that one of the parties might be prevented from fully pursuing its own separate interest. [2008 AICPA Conf]

When evaluating a legal entity in which all of the variable interests are held by related parties and de facto agents, the requirement for an enterprise to consider whether substantially all of the legal entity's activities either involve or are conducted on behalf of the related party group generally results in the legal entity meeting the substantially all condition (and often possessing the fifth VIE characteristic).

Example 4.7.80

All investors are related parties

Background

Investor1 and Investor2, related parties, form Legal Entity to manufacture golf carts. Investor1 holds a 55% economic interest and Investor2 holds a 45% economic interest. The investors must agree on all significant decisions, including approving the operating and capital budgets, and hiring, firing and setting the compensation of management.

Evaluation

Investor1 has disproportionately few voting rights in proportion to its economic interest because its voting rights are 50% while its economic interest is 55%.

When evaluating the substantially all condition, Investor1 must determine whether substantially all of Legal Entity's activities are conducted on behalf the related party group that includes both Investor1 and Investor2.

Legal Entity is a VIE because substantially all of Legal Entity's activities involve or are conducted on behalf of the related party group that includes Investor1 and Investor2, and Investor1 has disproportionately few voting rights.

Example 4.7.90
Some investors are related parties

Background

Partnership refurbishes and sells worn or damaged radial tires. The interests of its three investors are as follows.

	Allocation of profits and losses	Voting interest
Investor1, a trucking transportation service company	45%	1/3
Investor2, a manufacturer and refurbisher of radial tires for tractor trailers	10%	1/3
FinanceCo, an investment entity	45%	1/3

- All equity in Partnership is deemed to be at risk and sufficient to absorb expected losses.
- Investor1 and Investor2 are related parties.

Partnership enters into a 25-year exclusive outsourcing arrangement to have Investor2 refurbish all worn or damaged tires that the partnership will sell. Partnership estimates that 95% of the refurbished tires will also be sold to Investor2's independent tire dealerships. Sales of refurbished tires represent the only source of Partnership's revenues.

Evaluation

Investor1's voting rights (one-third) are disproportionate to its obligation to absorb expected losses (45%) through its equity interest. Related parties (Investor2 in this example) are ignored when evaluating whether the voting interests of some investors are disproportional to their economic interests in the entity (see Question 4.7.40).

In contrast, related parties are not ignored when evaluating whether substantially all of Partnership's activities are conducted on Investor1's behalf. Partnership's activities (i.e. refurbishing and reselling worn or damaged radial tires) are not substantially similar to Investor1's primary activities of transporting goods. However, they are substantially similar to Investor2's operations (refurbishing and selling radial truck tires) and Investor1 and Investor2 are a related party group.

Because Partnership's sales of refurbished tires to Investor2's independent tire dealers represent approximately 95% of Partnership's revenues, substantially all of Partnership's activities are deemed to be conducted on behalf of the related group that includes Investor1 and Investor2. Further, Investor1 has disproportionately few voting rights. As a result, Partnership is a VIE.

Example 4.7.100
Investor has a de facto agent

Background

Investor1 and Investor2 form Legal Entity to develop a luxury ski resort in the Midwest.

Investor1 is responsible for identifying the development site, identifying subcontractors, sourcing raw materials and directing all development-related activities. Once fully developed, Investor1 will manage and maintain the ski resort's operations.

Investor2 is not in the business of developing real estate and is holding its interest as a passive real estate investment.

The investors’ interests in Legal Entity are as follows.

	Economic interest	Voting interest
Investor1	25% Class A shares)	1/3
Investor2	25% Class A shares)	1/3

Investor1 has the power to direct Legal Entity’s most significant activities through its Class A shares, and Investor2’s Class B shares do not carry substantive kick-out or participating rights.

Under the venture agreement, Investor1 is prohibited from selling, transferring or encumbering its equity interest in Legal Entity without Investor2's prior consent. At Legal Entity’s inception, Investor2 requested this provision so that it would have adequate time to find a replacement developer and manager should Investor1 wish to sell its investment and exit the project. Investor2 does not have this restriction on its Class B shares.

Evaluation

The disproportionate condition is met because Investor2's voting interests (no decision-making rights) are disproportionate to its economic interest in Legal Entity (75% venture interest). However, the substantially all condition is not met. As a result, Legal Entity is not a VIE.

Note: If Investor2 was required to consider Investor1 a de facto agent because of the transferability restriction, it might conclude that substantially all of Legal Entity's activities (developing and managing real estate) involve or are conducted on the behalf of the related party group that includes Investor1 and Investor2. However, because this type of de facto agency relationship is not considered when evaluating the fifth VIE characteristic (see Question 4.7.70), the substantially all condition is not met, and Legal Entity is not a VIE.

4.8 Reconsideration of VIE/VOE status

Excerpt from ASC 810-10

Variable Interest Entities

> Reconsideration of Initial Determination of VIE Status

35-4 A legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its **expected losses** that reduce the equity investment. The initial determination of whether a legal entity is a VIE shall be reconsidered if any of the following occur:

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

An enterprise is not necessarily required to reconsider whether a VOE is a VIE, or vice versa, during each reporting period. Reconsideration is required only when certain events occur that may indicate the legal entity’s design has changed. A change in the design of a legal entity is a reconsideration event if it indicates:

— the entity’s equity investment at risk may not be sufficient; or
— the at-risk-equity investors’ interests may no longer have the characteristics of a controlling financial interest.

If an entity is…	A reconsideration event could result in the conclusion that…
a VIE	the entity is no longer a VIE
a VOE	the entity is a VIE

The reconsideration events included in Subtopic 810-10 are intended to capture circumstances that indicate there may have been a change in the design of the entity. [810-10-35-4]

A	Change in governing documents or contractual arrangements occurs that changes the characteristics or adequacy of the legal entity's equity investment at risk.
B	Equity investment is fully or partially returned to the equity investors, and other interests become exposed to the legal entity's expected losses as a result.
C	Legal entity's expected losses are increased due to the addition of activities or assets that were not anticipated at the later of the entity's inception or the latest reconsideration event.
D	Additional equity investment at risk is received, or the legal entity's activities are curtailed or modified in a way that decreases expected losses.
E	Equity investment at risk, as a group, loses the power from voting rights or similar rights of those investments to direct the activities of the legal entity that most significantly impact its economic performance.

Question 4.8.10

Has a reconsideration event occurred if a VOE incurs losses in excess of the amount expected?

Interpretive response: No. Losses that reduce a VOE's equity investment at risk do not give rise to a reconsideration event, even if the fair value of the VOE's equity is reduced to zero. On its own, this would not indicate that the VOE's equity is insufficient by design.

However, as a VOE incurs losses in excess of its expected losses, the likelihood increases that the VOE's design has or will change. If a VOE's losses result in the occurrence of events that are specifically listed as reconsideration events (A to E above), then a reconsideration of whether the VOE has become a VIE is required. If one or more of the reconsideration events occurs, the total fair value of the VOE's equity should be compared with the expected losses at that time to determine whether the entity is able to finance its activities without additional subordinated financial support (see chapter 10). The inability to finance activities without such additional support is an indicator that the VOE has become a VIE. However, a quantitative assessment may not be necessary; evaluating expected losses qualitatively may be conclusive.

For example, assume as a result of a VOE experiencing negative operating results, an existing agreement gives another party (e.g. a guarantor or lender) the power to direct the activities that most significantly impact the VOE's economic performance. This results in the equity-at-risk investors losing such power, which is reconsideration event E. Therefore, the entity's characterization as a VOE needs to be reassessed. Upon this reassessment, the VOE would be considered a VIE as a result of the equity-at-risk holders lacking power (see section 4.4). [810-10-35-4(e)]

Question 4.8.20

Could a change in US GAAP result in a reconsideration event?

Interpretive response: No. We do not believe that a new accounting standard constitutes a reconsideration event on its own.

However, a change in an accounting standard may result in a legal entity becoming a VIE if the entity must be reconsidered for other reasons (A to E above) after adoption of the new standard. For example, amendments to US GAAP might change the composition of a VOE's US GAAP equity between the date of the initial assessment and the date of a reconsideration event.

Depending on the nature of the amendments, a VOE may become a VIE if all or a portion of its equity investment at risk is no longer considered equity under US GAAP. For example, a reconsideration event occurring after the effective date of Topic 480 may have resulted in the reclassification of certain interests previously considered equity into liabilities in the entity's financial statements.

Question 4.8.30

Is a change in an entity's design a prerequisite for the reconsideration of a legal entity's VIE status?

Interpretive response: No. A change in a legal entity's design does not need to occur for a reconsideration event to arise. Instead, the occurrence of a reconsideration event requires an evaluation of whether there has been a change in a legal entity's design – i.e. the risks it was designed to create and distribute to its interest holders (see section 3.3).

The following are example reconsideration events (not exhaustive) that we believe may change the design of an entity.

Reconsideration event	Examples
Transactions affecting an entity's capital structure	— debt financing — refinancing (including troubled debt restructurings) or early retirements issuances of equity interests — capital contributions or distributions
Changes to an entity's business	— new asset acquisitions — new leases — entry into new business lines that increase the entity's expected losses and expected residual returns — disposal of a business
Revisions to an entity's legal agreements	— changes to service or outsourcing contracts — changes to an equity investor's voting rights

Reconsideration event	Examples
	— changes to or expiration of kick-out rights, liquidation rights, participating rights, or other rights affecting which party meets the power criterion (see section 6.4)

Each of these events would involve a change in the design of the legal entity if, upon the occurrence of the event:

— the adequacy of the entity's equity investment at risk changes in relation to the entity's expected losses (see chapter 10); or [810-10-35-4(a)]

— the at-risk equity investors either obtain or lose the characteristics of a controlling financial interest – i.e. the at-risk conditions discussed in section 4.3 either are no longer met, or one or both of those conditions is now met. [810-10-35-4(e)]

Nonsubstantive changes or events do not constitute a reconsideration event. Professional judgment based on consideration of all relevant facts and circumstances is important when evaluating whether an event is significant enough to warrant a reconsideration of an entity's VIE status.

Question 4.8.40

Is a transfer of an entity's debt from the original lender to a different lender a reconsideration event?

Interpretive response: No. This transfer does not result in a change to the characteristics or adequacy of a legal entity's equity at risk and therefore is not a reconsideration event.

The debt acquirer should evaluate the entity's original design or the design at the most recent reconsideration event, if any, to determine whether the entity is a VIE. If it is not practicable for the debt acquirer to perform this evaluation, the debt acquirer should evaluate the entity's design based on the facts and circumstances when it acquires the debt. If the entity is not deemed to be a VIE, the debt holder follows other applicable US GAAP to account for its interest.

Question 4.8.50

If an enterprise acquires a business that holds a variable interest in a legal entity, would the entity's VIE status need to be reconsidered?

Interpretive response: Not necessarily. The legal entity's VIE status does not need to be reassessed unless:

— its design has changed; or
— one of the reconsideration events in has occurred.

A business acquisition typically only transfers a variable interest between the two parties involved in the transaction; it does not change the design of the variable interest in the lower-tier entity or affect the characteristics or adequacy of the entity's equity investment at risk.

However, if the acquiring enterprise already has a variable interest in the legal entity, the acquisition requires a reconsideration of whether the entity qualifies for the business scope exception if it was previously used (see Questions 2.4.140 and 2.4.200).

Question 4.8.60

Does an enterprise need to reevaluate its use of the business scope exception when a reconsideration event occurs?

Interpretive response: Not necessarily. As discussed in Question 2.4.200, an enterprise needs to continuously evaluate its eligibility for the business scope exception as the factors affecting the conditions change. However, a reconsideration event may not necessarily affect the business scope exception conditions.

If, at the reevaluation date, none of the business scope exception conditions exist, we believe the enterprise:

— can continue to apply the scope exception; and
— is not required to reevaluate whether the legal entity is a business.

See Question 2.4.120 for guidance on the business scope exception.

Question 4.8.70

On the occurrence of a reconsideration event, is the sufficiency of the equity investment at risk based on its fair value or carrying amount?

Interpretive response: The fair value, not the carrying amount, of the legal entity's equity investment at risk should be used in evaluating whether it is sufficient. This is consistent with the measurement that would be used to evaluate the sufficiency of an entity's equity at risk when an enterprise first obtains a variable interest in the entity. See section 4.3 for guidance on equity at risk.

Question 4.8.80

Does every change made to an entity's governing documents or contractual arrangements give rise to a reconsideration event?

Interpretive response: No. A change in the entity's governing documents or contractual arrangements that meets either of the following triggers reconsideration event A, which requires reconsideration of whether the entity is a VIE: [810-10-35-4(a)]

— the change is substantive; or
— the change results in a change in the characteristics or adequacy of the entity's equity at risk.

Changes that do not meet one of the above are not reconsideration events.

Only substantive terms, transactions and arrangements (whether contractual or noncontractual) are considered (see Question 3.2.30). Transactions are disregarded if they do not have a substantive effect on:

— an entity's VIE status;
— an enterprise's power over a VIE; or
— an enterprise's obligation to absorb losses or its right to receive benefits of the entity.

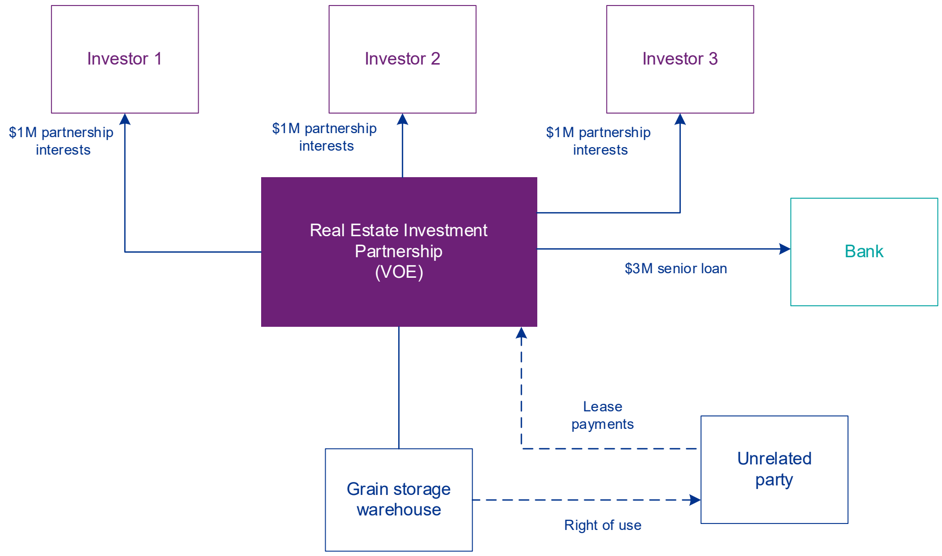
See Example 4.8.10 for an illustration of assessing changes to an entity's governing documents and contractual arrangements.

Example 4.8.10

Potential reconsideration events

Background

Real Estate Investment Partnership (Partnership) is formed to purchase and manage a grain storage warehouse. On formation, three equity investors contribute $1 million in exchange for partnership interests. Partnership also receives a $3 million senior loan from Bank. An unrelated party agrees to lease the entire warehouse at market terms for seven years. Partnership is considered a VOE upon formation.



The following scenarios are independent.

Scenario 1: Debt refinancing

During its second year of existence, Partnership refinances its senior debt following an increase in the fair value of its grain storage warehouse. The increase in the debt balance does not exceed the increase in the fair value of the grain storage warehouse. Proceeds received as a result of the refinancing are distributed to the equity investors.

Evaluation

The refinancing of the senior debt amounts to a change in a contractual arrangement, which could trigger reconsideration event A. However, we believe that reconsideration event is not triggered because the refinancing does not change the adequacy of Partnership's equity investment at risk.

Scenario 2: Lease extension

After three years, the terms of the lease are modified to extend its term from seven years to ten years. All other significant terms of the lease remain unchanged.

Evaluation

We do not believe the lease extension gives rise to reconsideration event A or C unless Partnership's expected losses changed as a result of the modification, and/or the extension results in changes to the adequacy of the equity at risk.

Scenario 3: Change to voting procedures

After four years in existence, the partnership agreement is modified so that partners may cast their votes by mail instead of having to vote in person at the annual meeting.

Evaluation

The modification represents a change to Partnership's governing documents, which potentially could trigger reconsideration event A. However, this change is not a substantive change and it does not affect the characteristics or adequacy of Partnership's equity at risk. As such, it does not require a reconsideration of whether Partnership is a VIE.

Scenario 4: Acquisition of additional assets

During Partnership's seventh year, Partnership purchases another grain warehouse for $5 million and leases it to a different unrelated party. As a result of the acquisition, Partnership's expected losses increase.

Evaluation

The acquisition of additional assets beyond those anticipated at Partnership's inception could trigger reconsideration event C. In this scenario, reconsideration event C is triggered because the acquisition increases Partnership's expected losses. Therefore, a reassessment of whether Partnership is a VIE must be performed.

Question 4.8.90

Is a troubled debt restructuring a reconsideration event?

Interpretive response: Yes. A TDR requires a reconsideration of whether a legal entity is a VIE and whether an enterprise is the primary beneficiary of the legal entity. In a TDR, economic events have demonstrated that the debtor's equity is not sufficient to permit it to finance its activities without additional subordinated financial support or a restructuring of the terms of its financing. As a result, the debtor would typically be identified as a VIE. [810-10-35-4(a)]

Further, the primary beneficiary of a debtor involved in a TDR may change as a result of the restructuring. See section 6.7 for guidance on primary beneficiary reconsideration.

Question 4.8.100

Is the conversion of noninterest-bearing accounts receivable into interest-bearing notes receivable a reconsideration event?

Interpretive response: Not necessarily. A conversion constitutes a reconsideration event if it results in a change to the characteristics or adequacy of the legal entity's equity at risk. Further, conversions of accounts receivable balances into notes receivable may be analogous to TDRs, which are reconsideration events because they are changes to the entity's contractual arrangements that change the adequacy of the legal entity's equity at risk (reconsideration event A).

However, if the conversion is not analogous to a TDR and does not change the characteristics or adequacy of the entity's at-risk equity, it does not constitute a reconsideration event. [810-10-35-4(a)]

Question 4.8.110

Is filing for bankruptcy or emerging from bankruptcy a reconsideration event?

Interpretive response: Generally, yes. Entities that file for bankruptcy are often VIEs because the equity investment at risk is not sufficient and/or the equity-at-risk group may no longer meet the power criterion – i.e. the bankruptcy court may control the entity.

Because of this, it is likely that the enterprise that consolidated an entity before the bankruptcy filing will be required to deconsolidate it after the bankruptcy filing. Therefore, we believe that a bankruptcy filing by a legal entity is a reconsideration event, requiring an enterprise to reassess a legal entity's VIE status, and potentially the primary beneficiary. [810-10-35-4(e)]

We believe that in most cases, a legal entity's emergence from bankruptcy also triggers reconsideration of the entity's VIE status. When emerging from bankruptcy, an entity's governing documents often establish new equity and other contractual arrangements that change the characteristics of the entity's equity investment at risk. If the characteristics of the entity's equity investment at risk change, reconsideration event A may be triggered, requiring the entity's VIE status to be reconsidered. [810-10-35-4(a)]

See sections 6.3 to 6.5 for guidance on the power criterion under the VIE consolidation model, and section 6.7 for guidance on reconsideration of the primary beneficiary. See Question 4.8.80 for guidance on evaluating changes made to an entity's governing documents and contractual arrangements.

Question 4.8.120

Does the replacement of temporary financing with long-term financing constitute a reconsideration event?

Interpretive response: Generally, yes. Replacing temporary financing with long-term financing is a change in a legal entity's contractual arrangements that triggers reconsideration event A. This is because the refinancing may change the characteristics or adequacy of the entity's equity investment at risk.

However, the conversion (i.e. rollover) from the temporary to long-term financing arrangement does not give rise to a reconsideration event if:

— the same lender provides both the temporary and long-term financing; and
— all significant terms (e.g. balance, term, interest rate, covenants) of both arrangements are substantially agreed to in connection with the initial financing.

In this case, the terms of both arrangements are considered when performing the initial determination of whether the entity is a VIE.

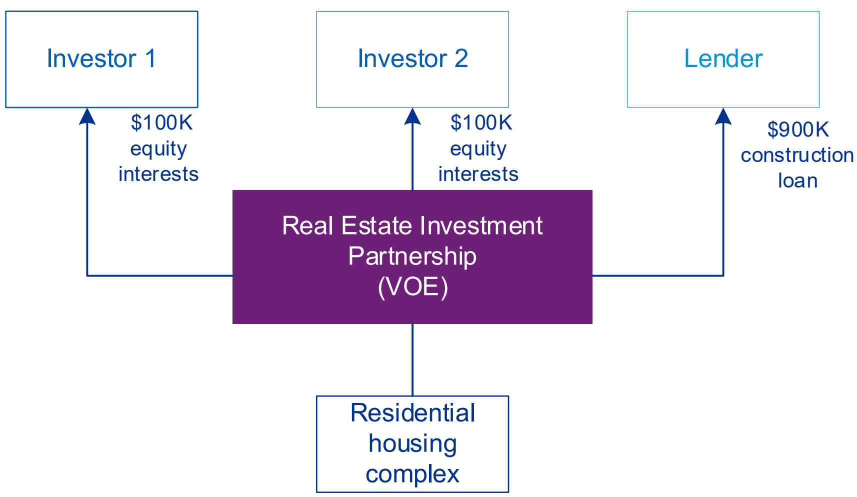
If the parties change the terms of the long-term financing on conversion from temporary financing, we believe additional analysis is necessary to determine whether the change is substantive. For example, a legal entity may negotiate for additional long-term financing proceeds at the conversion date if the fair value of the collateral increases while the temporary financing is in place. In this case, we believe the conversion is a reconsideration event only if it changes the adequacy of the equity investment at risk.

This is illustrated in Example 4.8.20.

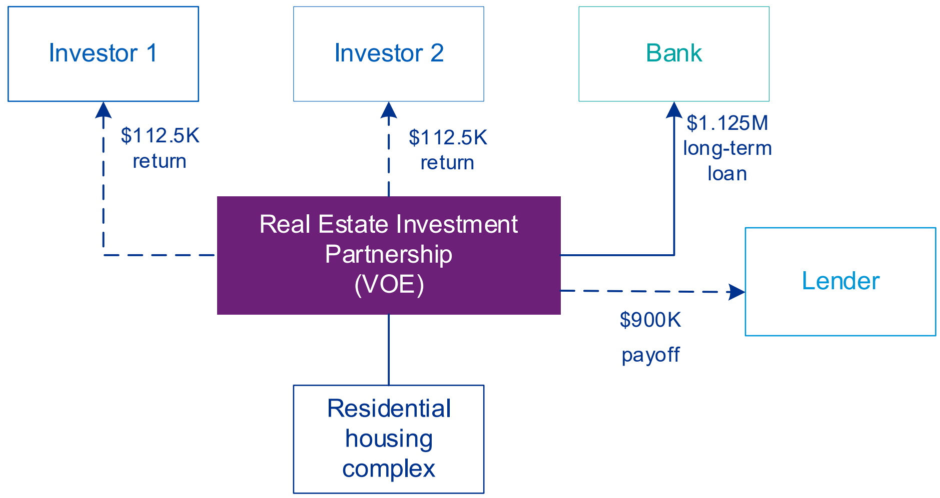
Example 4.8.20
Long-term financing replaces temporary financing

Background

Real Estate Investment Partnership (Partnership) is formed to develop a residential housing complex in New Jersey. Two investors contribute $100,000 in exchange for equity interests. Partnership also receives a temporary construction loan of $900,000 from a lender to help finance the project.



Upon completion, the housing complex has a fair value of $1,500,000. The fair value is higher than anticipated, so Partnership obtains long-term financing at 75% of the housing complex's fair value ($1,125,000) and uses the proceeds to repay the temporary construction loan ($900,000) and to return capital to the equity investors ($225,000).



Evaluation

In this example, replacing temporary financing with long-term financing does not necessarily require a reconsideration of whether Partnership is a VIE. This is because the fair value of Partnership's remaining equity investment at risk ($150,000) remains sufficient to permit it to finance its activities without subordinated financial support.

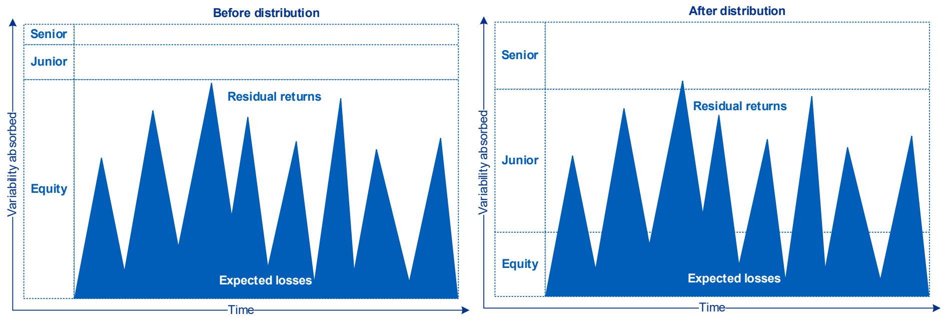
However, if the return of capital to the equity investors reduces the adequacy of the equity investment at risk, the conversion to long-term financing requires a reconsideration of whether Partnership is a VIE.

Question 4.8.130

Must an entity's VIE status be reconsidered upon each distribution to its equity investors?

Interpretive response: Not in all circumstances. Reconsideration event B is triggered when a legal entity's equity investment is fully or partially returned to the equity investors, and other interests become exposed to the legal entity's expected losses as a result. Therefore, if a legal entity's expected losses exceed the fair value of the equity after a distribution to equity investors, this reconsideration event is triggered because the distribution exposes other interests to the entity's expected losses.

The following diagram illustrates this scenario.



In contrast, a distribution does not constitute a reconsideration event if the fair value of the equity exceeds the expected losses following the distribution.

This concept is further illustrated in Example 4.8.30.

Question 4.8.140

Must an entity's VIE status be reconsidered if it begins paying dividends?

Background: A real estate investment partnership is formed to purchase and manage a retail shopping center. Several storefronts in the shopping center are leased at market terms to various unrelated entities. At the end of its third year, the partnership begins to pay annual dividends to its equity investors equal to 70% of its annual net income. Before paying the dividends, the partnership was not a VIE.

Interpretive response: No. Reconsideration event B is triggered when a legal entity's equity investment is fully or partially returned to the equity investors, and other interests become exposed to the legal entity's expected losses as a result.

We believe dividend distributions that represent returns **on** equity (and not returns **of** equity) typically do not give rise to a reconsideration event. However, distributions may give rise to a reconsideration event if:

— the fair value of the entity's equity at risk before the distributions was only marginally in excess of its expected losses; and
— the fair value of the entity's assets has declined substantially without requiring recognition of an impairment loss.

As a result, the fair value of the equity may have declined to a level that is less than the entity's expected losses. This would expose interests other than the equity at risk to expected losses of the entity.

Example 4.8.30
Returns of equity

Background

Real Estate Investment Partnership (Partnership) restructures its debt. Due to appreciation in the value of its retail shopping center, Partnership distributes amounts to its equity investors in excess of its net income.

Evaluation

If the return of capital exposes other variable interest holders (i.e. the lenders) to expected losses of Partnership, the loan restructuring and return of capital triggers reconsideration event B. This is because the fair value of equity after the distributions is less than Partnership's expected losses, thereby requiring the non-equity holders to absorb excess losses.

Conversely, if the fair value of the entity's equity at risk after the loan restructuring and distribution exceeds Partnership's expected losses, the distributions do not trigger reconsideration because Partnership's equity at risk remains sufficient to absorb the expected losses.

Question 4.8.150
Do all asset purchases and all sales require an enterprise to reconsider whether a legal entity is a VIE?

Interpretive response: Not necessarily. Asset purchases or sales trigger reconsideration event C only if they significantly change a legal entity's expected losses. For example, a legal entity may have acquired computers for all of its employees that, when aggregated, may be material to the fair value of the entity's assets or its operating results. However, if this purchase does not generate significant additional expected losses, it does not trigger a reconsideration event. [810-10-35-4(c)]

Question 4.8.160
Has a reconsideration event occurred if the equity-at-risk investors, as a group, obtain the power to direct the legal entity's most significant activities?

Interpretive response: No. The equity-at-risk investors losing power to direct the legal entity's most significant activities through the rights of their equity interests is reconsideration event E. However, this test is a one-way test. It triggers reconsideration of whether an entity is a VIE only when the entity would become a VIE, not when a VIE would become a VOE. This is because the equity-at-risk investors gaining the power to direct the most significant activities is not a listed reconsideration event. [810-10-35-4(e)]

Nevertheless, the circumstances that lead to the equity-at-risk investors, as a group, obtaining such power may trigger one of the other four reconsideration events. For example, those circumstances may trigger reconsideration event D if they result in the legal entity: [810-10-35-4(d)]

— receiving an additional at-risk equity investment; or
— curtailing or modifying its activities in a way that decreased its expected losses.

Question 4.8.170

Does a specific event need to occur for equity-at-risk holders, as a group, to lose the power to direct the most significant activities?

Interpretive response: Generally, yes. Typically, the holders of the equity investment at risk, as a group, do not lose the power to direct the most significant activities unless a specific event occurs. However, this event does not necessarily need to involve the revision of existing agreements or the execution of new agreements. Instead, the loss of power could also occur through mechanisms built into existing arrangements between two parties.

For example, the terms of a loan may provide the lender with the power to direct activities upon an event of default such as a decline in the fair value of the collateral below the outstanding principal balance of the loan; see Question 6.3.160 for guidance on evaluating contingent power.

A lender also may obtain the right to foreclose on the collateral if there is a default on the borrower's (i.e. legal entity's) loan. We believe a lender's foreclosure right should be evaluated in the same manner as a substantive unilateral kick-out right if:

— the collateral is of such significance to the legal entity that decisions about the operations of the collateral represent the decisions that most significantly impact the entity's economic performance;

— the legal entity does not have a substantive ability to cure the default; and

— there are no other substantive barriers to the lender's ability to exercise its right to foreclose on the collateral.

This right, if exercised, results in a loss of power on the part of the holders of the borrower's (i.e. legal entity's) equity at risk. See section 6.4 for guidance on kick-out rights.

5. Who consolidates a VOE?

Detailed contents

Item significantly updated in this edition: #

Examples

5.3 Effect of noncontrolling rights – participating rights

Questions

Examples

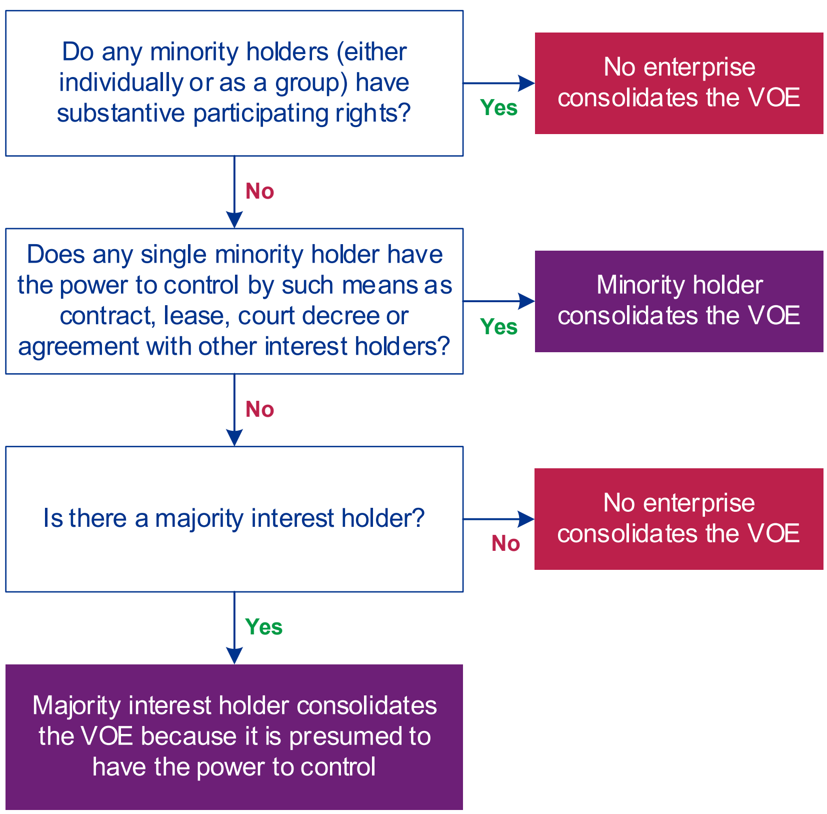
5.1 How the standard works

Under the VOE consolidation model, the enterprise with a controlling financial interest in the VOE consolidates the VOE. This model is applied only after it is determined that:

— no scope exception to consolidation under Topic 810 applies (see section 2.3);
— no scope exception to consolidation under the VOE consolidation model applies (see section 2.5); and
— the legal entity is not a VIE (see chapter 4).

If no enterprise has a controlling financial interest, the VOE is not consolidated under either of the two primary consolidation models in Topic 810.

A controlling financial interest is an equity interest held by a single enterprise that has the ability to control the decisions made in the ordinary course of the VOE's business (the 'power to control'). There is a rebuttable presumption that this control rests with the enterprise that has majority voting control (the 'majority holder'). However, control can be held by a minority holder (a 'single minority holder') or by no equity interest holders, as the following decision tree indicates.



Limited partnerships

The VOE consolidation model for limited partnerships is similar, except the LP owning the majority of the partnership's kick-out rights (if any) is presumed to have the controlling financial interest unless other parties have substantive participating rights. Further, as with other legal entities, the controlling financial interest can rest with a partner other than the LP with the majority of kick-out rights.

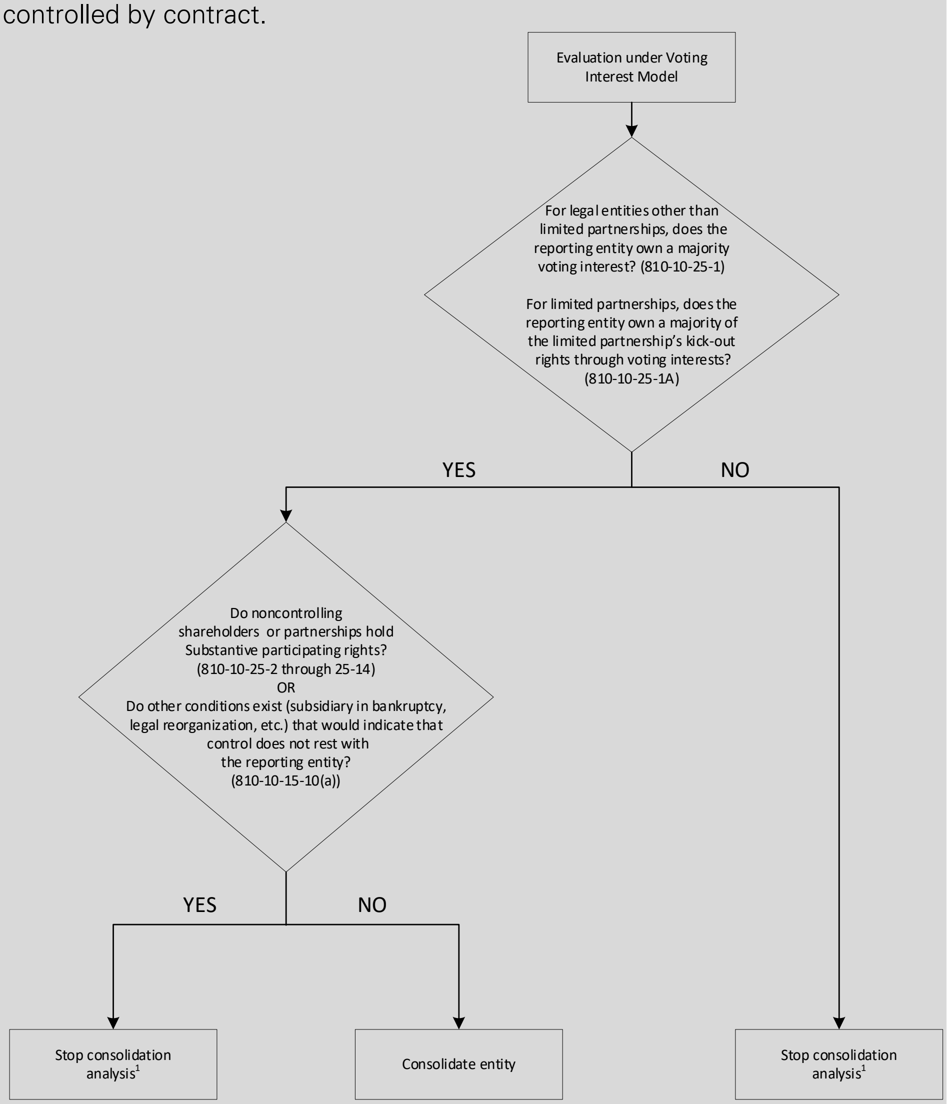
5.2 Controlling financial interest

5.2.10 Overview

Excerpt from ASC 810-10

General

05-6 The following flowchart provides an overview of the guidance in this Subtopic for evaluating whether a reporting entity should consolidate another legal entity. The flowchart does not include all of the guidance in this Subtopic and is not intended as a substitute for the guidance in this Subtopic. For example, the flowchart does not illustrate the consolidation analysis for entities controlled by contract.



[1]Consolidation is not required; however, evaluation of other generally accepted accounting principles (GAAP) may be relevant to determine recognition, measurement, or disclosure.

General

> Entities

15-8 For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

15-8A Given the purpose and design of limited partnerships, **kick-out rights** through voting interests are analogous to voting rights held by shareholders of a corporation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership's kick-out rights through voting interests. The power to control also may exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree.

15-9 A majority-owned **subsidiary** is an entity separate from its parent and may be a **variable interest entity** (VIE) that is subject to consolidation in accordance with the Variable Interest Entities Subsections of this Subtopic. Therefore, a reporting entity with an explicit or implicit interest in a legal entity within the scope of the Variable Interest Entities Subsections shall follow the guidance in the Variable Interest Entities Subsections.

General

25-1 For **legal entities** other than limited partnerships, consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest is ownership of a majority voting interest, but in some circumstances control does not rest with the majority owner.

25-1A Given the purpose and design of limited partnerships, **kick-out rights** through voting interests are analogous to voting rights held by shareholders of a corporation. Consolidation is appropriate if a reporting entity has a controlling financial interest in a limited partnership and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest in a limited partnership is ownership of a majority of the limited partnership's kick-out rights through voting interests, but, in some circumstances, control does not rest with the majority owner.

Under the VOE consolidation model, the interest holder that has the controlling financial interest in the legal entity consolidates the entity, provided a scope exception does not apply (see sections 2.3 to 2.5). If none of the legal entity's equity interest holders have a controlling financial interest, the legal entity is not consolidated. [810-10-25-1 – 25-1A]

A controlling financial interest is an interest held by a single enterprise that has the ability to control the decisions made in the ordinary course of the VOE's business (the 'power to control'). There is a rebuttable presumption that the majority holder has the power to control.

However, control does not rest with a majority holder if the NCI holder(s) has substantive participating rights or if the power to control has been conveyed to a single minority interest holder through an agreement with other equity holders.

Although Topic 810 also states that control of a VOE could be conveyed to a single minority holder by other means (e.g. through contract, court decree, lease agreement), that situation is rare because those arrangements typically cause the legal entity to be a VIE (see section 4.4). [810-10-15-8, 25-1, 25-5]

Question 5.2.10

How is the majority holder identified?

Interpretive response: There is a rebuttable presumption that the majority holder has the power to control – i.e. the ability to control the decisions made in the ordinary course of the VOE's business. [810-10-15-8 – 15-8A]

'Majority holders' in this context are defined as follows. [810-10-15-8 – 15-8A, 25-1 – 25-1A]

Limited Partnerships	Ownership by one LP, directly or indirectly, of > 50% of the limited partnership's kick-out rights through voting interests ('majority kick-out right holder')
All other legal entities	Ownership by one reporting entity, directly or indirectly, of > 50% of the outstanding voting shares ('majority shareholder')

However, control does not rest with a majority holder if:

— NCI holder(s) has substantive participating rights that negate the power to control held by the majority holder; or [810-10-25-5]

— a single minority holder has the power to control the legal entity through an agreement with other equity holders. [810-10-15-8, 25-1]

Although Topic 810 also states that control of a VOE could be conveyed to a single minority holder by other means (e.g. through contract, court decree, lease agreement), we believe that situation is rare. When control of a legal entity is conveyed by those means, the legal entity typically is a VIE because the equity-at-risk lacks the power to direct the entity's most significant activities (see section 4.4). As a result, we believe this guidance generally is applied only by enterprises that are exempt from the VIE consolidation model – e.g. NFPs (see sections 2.4.20 and 9.4). [810-10-15-8]

See section 5.2.20 for further guidance on determining the controlling financial interest in a limited partnership. See section 5.3 for guidance on determining when participating rights are substantive.

Question 5.2.20

On what date does an enterprise with the power to control begin consolidating a VOE?

Interpretive response: An enterprise with the power to control a VOE begins consolidating it on the date that the power is obtained. Further, it must reassess the effect of noncontrolling rights if there is a significant change in the terms or exercisability of those rights. [810-10-25-5]

Similar to evaluating significant influence under Topic 323 (equity method), we believe that when an enterprise is determining whether it (or another party) is a majority holder, it includes only those instruments with current voting privileges. When the VOE has outstanding warrants, options, conversion privileges or other instruments that represent future potential voting rights, an enterprise does not assume exercise or conversion of those rights when determining its voting interest in the VOE. These rights affect the enterprise's voting interest in the VOE only when they are exercised or converted. [323-10-15-9]

Question 5.2.30

Can the power to control be obtained without the investor increasing its ownership interest?

Interpretive response: Yes. Although the power to control is often obtained through the purchase of additional voting interests, an enterprise needs to continually monitor the VOE for other changes that may trigger consolidation.

Common examples of changes that may result in an enterprise obtaining the power to control include:

- changes in board rights;
- treasury stock transactions;
- the VOE's emergence from bankruptcy;
- lapse of rights previously contractually granted by the enterprise to other investors; and
- lapse or removal of severe foreign exchange restrictions, controls or other governmentally imposed uncertainties.

When an enterprise obtains the power to control a VOE, it immediately begins consolidating (see Question 5.2.20). See chapter 7 for guidance on initial recognition and measurement.

Question 5.2.40#

How does an enterprise account for a commitment (or option) to purchase a controlling financial interest in an equity method investee?

Background: An enterprise may purchase an equity interest in an investee with a commitment to purchase additional equity interests at a future date for a fixed price. These arrangements may be executed using a purchased call option or a forward agreement and may be freestanding or embedded in the investor's existing equity interest.

When the enterprise is determining whether it (or another party) is a majority holder, it includes only those instruments with current voting privileges – i.e. it does not assume exercise or conversion of those rights when determining its voting interest in the VOE (see Question 5.2.20).

Interpretive response: When evaluating what US GAAP applies to these arrangements, an enterprise first applies Topic 815 to determine if the arrangement is a freestanding derivative or an embedded feature in the existing shares.

Freestanding instruments

If the instrument is in the scope of the 'certain contracts on debt and equity securities' Subsections of Topic 815, an enterprise accounts for it similar to an equity security under Topic 321. [815-10-15-141 – 15-142]

However, Topic 815 does not specifically address whether forward contracts and purchase options that on settlement would result in consolidation are out of the scope of the 'certain contracts on debt and equity securities' Subsections of Subtopic 815-10. As a result, enterprises with such freestanding instruments generally measure them at cost during the forward or option period.

Further, freestanding instruments to purchase a controlling financial interest are not generally accounted for as derivatives either because the contract: [815-10-15-74(c), 15-59, 15-83(c)]

- when settled results in a business combination;
- meets the scope exception in Topic 815 for contracts that are not traded on an exchange; or
- cannot be settled net.

Embedded features

An enterprise with a commitment or option to purchase equity that is embedded in its existing shares evaluates the feature under Topic 815 to determine whether it must account for the feature separately as a derivative.

If the enterprise must account for the feature separately as a derivative, it measures the derivative at fair value during the forward or option period. However, similar to freestanding instruments, we believe it would be rare for such an embedded feature to require separate accounting under Topic 815. [815-15-25-1, 30-2, 35-2A]

If the investor does not account for the feature separately under Topic 815 during the forward or option period, it generally accounts for the feature when (or if) settled.

Accounting on exercise

An enterprise that exercises an option to purchase a controlling financial interest includes the derecognition of the option asset (if any) and payment of the exercise price as part of the consideration in acquisition accounting. We understand there are different perspectives in practice about whether the option being exercised should be remeasured at the acquisition date similar to a previously held equity interest in a business combination. Some view these options similarly to any other previously held equity interest and believe they should be remeasured. Others view the option as an executory contract that should not be remeasured. As such, either view may be appropriate depending on the facts and circumstances. However, we believe it is not appropriate to remeasure an option that when exercised results in an asset acquisition.

The initial measurement of the assets, liabilities and NCI of the newly consolidated subsidiary depends on whether the transaction is a business combination (see Question 7.2.90) or an asset acquisition (see Questions 7.3.110 and 7.3.130).

Example 5.2.10
Call arrangement

Background

Enterprise acquired 19% of Legal Entity and simultaneously entered into a freestanding purchased call arrangement. The purchased call arrangement is outside the scope of Topic 815.

In addition to its 19% equity interest and the call arrangement, Enterprise:

— has one of five seats on the board of directors; and
— provides all of Legal Entity's debt financing.

Settlement of the call arrangement is expected to result in Enterprise acquiring the remaining equity interests of Legal Entity.

Legal Entity is a VOE.

Evaluation

Enterprise does not have the power to control Legal Entity. This is because Enterprise lacks:

— a majority voting interest in Legal Entity;
— the ability to control Legal Entity's board of directors; and
— the power to control Legal Entity through other means.

Enterprise applies the equity method of accounting because it does not have the power to control Legal Entity but does have the ability to exercise significant influence.

Enterprise accounts for the call at cost during the forward period.

Enterprise allocates the consideration transferred to the equity method investment and call consistent with the guidance on asset acquisitions. See Question 7.3.60 and section 3 of KPMG Handbook, Asset acquisitions, for additional discussion of allocating cost.

On settlement of the call arrangement, Enterprise reassesses the power to control. On receipt of the remaining equity interests, Enterprise consolidates Legal Entity (see section 7.2.20).

Question 5.2.50

Can an indirect investment make an enterprise a majority holder?

Interpretive response: It depends. An enterprise should presume it has the power to control a VOE if it holds a majority of the voting interest through direct and indirect interests, but only if it has the power to control those interests. The same guidance applies to a holder of a majority of the substantive kick-out rights if the VOE is a limited partnership or similar entity.

Example 5.2.20

Control through indirect interests

The following scenarios demonstrate evaluating control through indirect interests.

Scenario 1: Investments through consolidated subsidiaries

Enterprise has three consolidated subsidiaries: Sub1, Sub2 and Sub3.

Each subsidiary purchase 30% of the outstanding voting common stock in VOE. If Sub1, Sub2 and Sub3 were unrelated parties, their direct 30% investments would not make them individually majority holders or give them the power to control VOE.

Enterprise is the majority holder of VOE through its indirect interests held by its consolidated subsidiaries.

Because Enterprise has the power to control Sub1, Sub2 and Sub3, it is presumed to have the power to control VOE through those subsidiaries, and therefore consolidates VOE. Each of the subsidiaries accounts for its investment in VOE under the equity method in its separate financial statements.

Scenario 2: Investments through NCI

Enterprise owns 50% of the voting shares of Investee and accounts for its investment using the equity method. Enterprise owns 100% of the voting shares of Sub and consolidates it.

Investee and Sub each have a 50% voting interest in VOE.

Enterprise is not the majority holder of VOE through its indirect interests held by Investee and Sub because Enterprise does not have the power to control Investee – i.e. it controls only 50% of the voting interests of VOE through its investment in Sub.

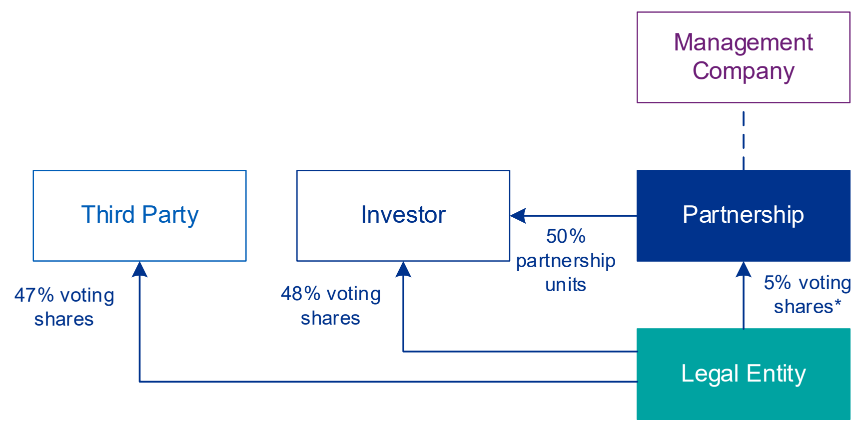
Note: These arrangements are often highly structured and therefore all facts and circumstances should be considered. Although Enterprise is not the majority holder of VOE, it may still have the power to control through other means – e.g. through an agreement with other equity holders that converts Investee's shares to non-voting or one that requires Investee to vote in concert with Enterprise.

Example 5.2.30

Majority ownership through voting and non-voting shares

Background

Voting and non-voting shares are held by several parties as follows.



*effectively non-voting due to partnership agreement

Under the partnership agreement, Management Company and Investor are prohibited from exercising their joint voting rights on Legal Entity common shares held by Partnership.

Management Company and Investor are not related parties.

Evaluation

Although Investor is prohibited from exercising the voting rights of the shares held by Partnership, Investor has the majority of the effective voting shares of Legal Entity.

The structure effectively converts the voting common shares held by Partnership into non-voting common shares. As a result, the number of total outstanding voting common shares is reduced for the amount held by Partnership. This increases the active voting percentage ownership held directly by Investor from 48% to 50.5%: 48% ÷ (100% - 5%).

Accordingly, Investor has the power to control Legal Entity and should consolidate it in its financial statements.

Question 5.2.60

Does an enterprise include a VOE's shares that are held in trust when measuring its ownership interest?

Interpretive response: No. An enterprise that holds shares in a fiduciary capacity should not include those shares when measuring its equity interest.

This situation occurs most often with bank investors and their trust departments. For example, a bank holds a 20% interest in a VOE's voting common stock and its trust department holds 35%. The bank does not add the trust department's 35% interest to its 20% when evaluating whether it is presumed to have the power to control the VOE. This is because the trust department is legally required to vote its shares in the best interest of the trust's beneficiaries, which may not be in the bank's best interest.

However, there may be situations in which an enterprise holds an incremental indirect interest in a VOE through a similar arrangement, but it may still have the power to control through other means (see Question 5.2.50). Evaluating these arrangements can be highly judgmental and all facts and circumstances should be considered.

Example 5.2.40

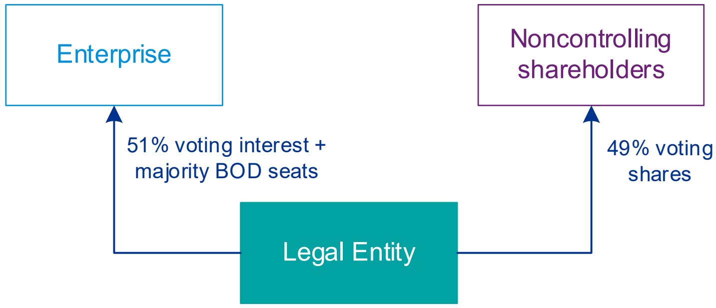
Reduction in voting shares by majority holder: retaining majority voting interest

Background

Enterprise holds 51% of the voting shares in Legal Entity and consolidates it under the VOE consolidation model. On January 1, it contributes 16% of the shares to its pension plan.

The trustee of the pension plan is a third party to both Enterprise and Legal Entity. Under the voting proxy, Enterprise retains the voting rights associated with the shares held by the pension plan and Enterprise continues to appoint a majority of Legal Entity's board of directors. The voting proxy the pension plan has given Enterprise is irrevocable and perpetual through the plan's sale of Legal Entity shares.

The noncontrolling shareholders do not have participating rights.



Evaluation

Enterprise continues to consolidate Legal Entity after January 1 because:

- it controls greater than 50% of the voting interests through the voting proxy,
- the voting proxy is irrevocable and perpetual while the pension plan holds the Legal Entity shares; and
- the noncontrolling shareholders lack substantive participating rights.

Question 5.2.70

How do noncontrolling rights impact a majority holder's control?

Interpretive response: A noncontrolling right is a right that the NCI holder(s) has to impact the legal entity's operations. Such a right is a substantive participating right if it gives the holder(s) the ability to block significant decisions made in the ordinary course of a VOE's business by the majority holder (see Question 5.3.10).

A substantive participating right held by the NCI holder(s) negates the presumption that the majority holder has the power to control. Substantive participating rights held by the NCI holder(s) also prevent a single minority holder from obtaining the power to control through other means. [810-10-25-1 – 25-3]

Substantive participating rights are sometimes referred to as 'veto rights' and they essentially allow the NCI holder(s) to effectively participate in significant financial and operating decisions expected to be made in the ordinary course of the legal entity's business. [810-10-25-1 – 25-2, 25-5 – 25-6]

The likelihood that a veto right will be exercised by the NCI holder(s) is not considered in assessing whether a noncontrolling right is a substantive participating right. Instead, it is the ability of the NCI holder(s) to exercise the right that is relevant. [810-10-25-12]

See section 5.3 for guidance on participating and other noncontrolling rights.

Question 5.2.80

Do all noncontrolling rights impact a majority holder's control?

Interpretive response: No. Not all rights granted to NCI holder(s) are deemed to be substantive participating rights when evaluating the majority holder's control. Protective rights do not provide the NCI holder(s) with the ability to participate in significant decisions made in the ordinary course of business. Therefore, such rights do not overcome the presumption of control by the majority shareholder or majority kick-out right holder (or negate the power of control held by a single minority holder). [810-10-25-7, 25-10 – 25-12]

Examples of protective rights include: [810-10-25-10]

— amendments to articles of incorporation of the legal entity;

— pricing on transactions between the majority shareholder or majority kick-out right holder and the legal entity and related self-dealing transactions;

— liquidation of the legal entity (in the context of Topic 852 (reorganizations)) or a decision to cause the legal entity to enter bankruptcy or other receivership;

— acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business; noncontrolling rights relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances (see Question 5.3.30); and

— issuance or repurchase of equity interests.

Section 5.3 discusses participating and protective rights in greater detail.

Question 5.2.90

How does a minority holder's right to control the board of directors affect the control analysis?

Interpretive response: It depends. It is important to consider at what level decisions are made when evaluating whether control of the board affects which party has the power to control a VOE. [810-10-25-13(b)]

Often the board of directors is a pass-through mechanism for the exercise of the shareholders' rights (see Question 6.4.60) and few decisions are submitted to the shareholders or LPs for a vote. In this case, a minority interest holder has a controlling financial interest in a VOE if:

— it has the unilateral ability to select the requisite number of board members necessary to control the board; and

— the board has the power to control the VOE – i.e. the VOE's governing documents give the board the ability to make decisions in the ordinary course of business (see Question 5.3.70).

Conversely, such a minority interest holder does *not* have a controlling financial interest in a VOE if:

— the board has only substantive participating rights; or
— another NCI holder(s) has substantive participating rights over the decisions made by the board.

In those situations, the majority holder also lacks the power to control the VOE and no party consolidates the VOE.

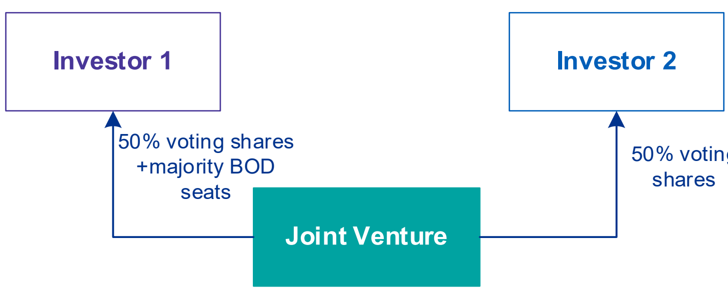
See Question 4.4.140 for guidance on how to evaluate the rights of the board of directors when determining whether a legal entity is a VIE.

Example 5.2.50
Majority board representation in a joint venture

Background

Investor1 is an SEC registrant and currently accounts for its 50% ownership in Joint Venture (JV) using the equity method of accounting. Under JV's original charter, Investor1 and Investor2 each have 50% of voting shares and each have equal representation on the board of directors as a result of their equity interests. The board has the power to control JV.

In connection with a recent restructuring of a loan from Investor1 to JV, the number of board seats was expanded by one. Investor1 has been granted this additional board seat, which it retains only if it remains an equity holder. Investor2 has only protective rights with regard to decisions made by the board.



Evaluation

Investor1 has the power to control JV through its majority representation on the board. Investor1's power to control is obtained through its:

— majority representation on the board (which has the power to control); and
— 50% ownership in voting shares.

Investor1 should start consolidating JV as of the date it gained a majority of the board seats (see section 7.2.20).

Question 5.2.100

Does the founder of a Capitalized Manager Vehicle consolidate it under the VOE consolidation model?

Background: Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC and other regulators to prescribe rules requiring many sponsors of securitizations of asset-backed securities (ABS) to retain a portion of the credit risk of the assets collateralizing the asset-backed securities. Unless an exemption applies, under the Risk Retention Rules, sponsors of securitizations that issue ABS must retain an eligible horizontal residual interest (as defined in the rules), or an eligible vertical interest (as defined by the rules), or a combination of both.

In some situations, an enterprise (the founding enterprise) may create an investment advisory entity, referred to as a Capitalized Manager Vehicle (CMV), to sponsor a securitization of ABS under the Risk Retention Rules. The CMV may be created for a variety of reasons, including eliminating the founding enterprise's role as the sponsor of the securitization. Eliminating this role may be necessary to address capital adequacy considerations applicable to founding enterprises that are financial institutions – i.e. the required retained interests under the Risk Retention Rules may negatively affect certain capital adequacy tests.

Each CMV may have its own unique characteristics and enterprises may have different economic interests in CMVs they are involved with. In our experience, some CMVs and involvement with CMVs by a founding enterprise have the following characteristics.

— The CMV is entirely equity capitalized largely by parties unrelated to the founding enterprise with no individual investor owning more than 25% of the CMV's equity. All equity investments are classified by the CMV as permanent equity.

— The founding enterprise holds no more than 10% of the CMV's equity and is not committed to make any future investments in the CMV.

— All significant operating and capital decisions of the CMV are controlled by majority vote of the CMV's board of directors – comprising a majority of individuals selected by parties unrelated to the founding enterprise.

— The day-to-day activities of the CMV are managed by an investment committee appointed by and subject to removal by majority vote of the CMV's board of directors. Although employees of the founding enterprise may serve on the investment committee, the investment committee is solely responsible for carrying out the decisions reached by the CMV's board of directors.

— Certain personnel, credit analysis, loan management, middle office, back office and other services may be provided by the founding enterprise subject to the ongoing approval of a majority of the CMV's board of directors. The founding enterprise receives a percentage of the fixed management fee earned by the CMV on securitizations of ABS that the CMV sponsors and manages.

— The CMV is expected to invest in ABS issued by securitizations it sponsors and manages to comply with the Risk Retention Rules.

Interpretive response: Each enterprise needs to evaluate its involvement with a CMV or similar entity based on the specific facts and circumstances. However, the SEC staff did not object to a founding enterprise's conclusion to not consolidate a CMV it created with the characteristics described in the background. The SEC staff confirmed this conclusion in a 2015 speech. [2015 AICPA Conf]

We understand the SEC staff did not object to the founding enterprise's conclusions for the following reasons.

The CMV is not a VIE

Neither the first VIE characteristic (insufficient equity at risk) nor the second characteristic (lack of power to direct significant activities) were present. As a result, the founding enterprise concluded (and the SEC staff did not object) that the CMV was not a VIE (see Example 4.4.90).

The founder does not consolidate the CMV

Because the CMV is not a VIE, it should be evaluated for consolidation using the VOE consolidation model. The usual condition for a controlling financial interest in a VOE is ownership of a majority voting interest (Question 5.2.10).

The founding enterprise does not hold a majority voting interest because it does not control a majority of the CMV's board of directors (see Question 5.2.90); nor is control exercised through other means. As a result, the founding enterprise should not consolidate the CMV; it should apply the equity method of accounting to its investment in the CMV.

Question 5.2.110

Do substantive participating rights held by non-equity interests overcome the presumption of control by a majority holder?

Interpretive response: Yes. We believe that a non-equity interest holder's ability to block decisions that the majority holder makes in the ordinary course of business can be a substantive participating right and therefore overcome the presumption of consolidation by a majority holder.

However, those rights result in the legal entity being a VIE if they:

— are unilaterally exercisable – i.e. exercisable by a single party, including its related parties and de facto agents; and
— relate to the activities that most significantly impact the entity's economic performance.

See Question 4.4.120 for guidance on how to consider rights held outside of the equity-at-risk group in the VIE analysis.

Question 5.2.120

When does a for-profit corporate sponsor of a charitable organization have the power to control the organization?

Interpretive response: We believe that a for-profit corporate sponsor of a charitable organization has the power to control the organization only if it:

— has a direct financial interest in the organization; and
— controls the organization.

For example, Enterprise may establish a Political Action Committee (PAC) to accept voluntary contributions from higher-level employees, directors and shareholders for disbursement to political candidates who have taken responsible positions on issues affecting Enterprise. In accordance with its bylaws, Enterprise cannot make contributions to the PAC and does not have a residual interest in its net assets; therefore it does not have a direct financial interest.

The PAC operates as a tax-exempt political organization within the meaning of Section 527(e)(1) of the Internal Revenue Code. It is not organized for profit and no part of net earnings benefit Enterprise or Enterprise’s employees. In the event of dissolution, assets of the PAC will be transferred to another qualifying NFP. The PAC has no members or capital stock. The affairs of the PAC are managed by its board of directors, which is appointed by Enterprise's CEO. The board members have the authority to make changes to the bylaws and dissolve the PAC.

Because the PAC is not subject to the VIE consolidation model, it is evaluated for consolidation under the VOE consolidation model. The PAC is a qualifying NFP under relevant tax law. Because of the inherent limits imposed by this status, the corporate sponsor likely would conclude that it does not consolidate a PAC if it does not:

— have a direct financial interest in the PAC; and
— substantively control the PAC, notwithstanding the CEO's authority to appoint the PAC's board of directors.

The FASB addressed a similar fact pattern relative to charitable foundations in its 1999 revised Exposure Draft, Consolidated Financial Statements: Purpose and Policy. The FASB reasoned that a charitable foundation established to qualify as a charitable organization under the Internal Revenue Code should not be consolidated by the sponsoring organization (even when the sponsoring organization controls the foundation's board) because the sponsoring organization/directors lacked control over the foundation. The exposure draft was never finalized and issued as an amendment to the Codification; however, we believe it gives some relevant insight into the underlying principles behind consolidating NFPs and may be used as a data point to support the conclusion not to consolidate a PAC.

We understand that some may have taken an alternative view that a PAC is being used by an enterprise in a manner similar to a VIE to circumvent the VIE consolidation model (see Example 2.4.20). Others have analogized to AICPA guidance that addresses an NFP's interest in a PAC and concludes that an NFP consolidates a PAC under Subtopic 958-810. [TQA 6140.10]

Note: The FASB added for-profit consolidation of an NFP to its agenda in 2020 but later dropped the project after its staff completed research on the extent of diversity in practice. The staff's research showed that for-profit sponsors predominantly do not consolidate their NFPs so the issue is not sufficiently pervasive to amend GAAP. Further, some Board members stated that a for-profit entity that does consolidate its NFP could consider a voluntary change in accounting policy that would result in deconsolidation as long as the requirements of Topic 250 on accounting changes are met; see section 3.3 of KPMG Handbook, Accounting changes and error corrections.

Question 5.2.130

What consolidation model does an NFP apply to a for-profit entity?

Interpretive response: An NFP that is subject to the VIE scope exception applies Subtopic 958-810 when evaluating whether to consolidate a legal entity (see Question 2.4.30). Under Subtopic 958-810, whether the for-profit legal entity is a partnership will impact the consolidation analysis as follows.

Legal entity is a partnership	Legal entity is not a partnership
An NFP that is a GP is presumed to control the limited partnership, regardless of the extent of its ownership interest – unless the LPs have substantive participating or kick-out rights. However, an NFP does not apply consolidation guidance for an investment in a for-profit limited partnership or similar legal entity if the partnership interest is reported at fair value under US GAAP.	An NFP applies the general Subsections of 810-10 that apply to VOEs.

See section 5.2.20 for guidance on evaluating whether kick-out rights are substantive. See section 5.3 for guidance on evaluating whether participating rights are substantive.

See chapter 9 for additional guidance on Subtopic 958-810.

5.2.20 Controlling financial interests in limited partnerships

Excerpt from ASC 810-10

General

05-3 Throughout this Subtopic, any reference to a **limited partnership** includes limited partnerships and similar **legal entities**. A *similar legal entity* is an entity (such as a limited liability company) that has governing provisions that are the functional equivalent of a limited partnership. In such entities, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner.

General

> Kick-Out Rights

25-14A For limited partnerships, the determination of whether **kick-out rights** are substantive shall be based on a consideration of all relevant facts and circumstances. For kick-out rights to be considered substantive, the limited partners holding the kick-out rights must have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to, the following:

a. Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
b. Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal
c. The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement
d. The absence of an explicit, reasonable mechanism in the limited partnership's governing documents or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights
e. The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

25-14B The limited partners' unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not be deemed a kick-out right. The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners shall not be required to be contractual for a withdrawal right to be considered as a potential kick-out right.

25-14C Rights held by the limited partners to remove the general partners from the partnership shall be evaluated as kick-out rights pursuant to paragraph 810-10-25-14A. Rights of the limited partners to participate in the termination of management (for example, management is outsourced to a party other than the general partner) or the individual members of management of the limited partnership may be substantive participating rights. Paragraphs 810-10-55-4N through 55-4W provide additional guidance on assessing kick-out rights.

20 Glossary

Kick-Out Rights (Voting Interest Entity Definition) – The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

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

In a limited partnership, the GP typically makes decisions in the ordinary course of the partnership's business. However, the LPs in a partnership that is a VOE have substantive participating rights and/or substantive kick-out rights that are exercisable by a single LP or a simple majority of all the LP voting interests (see section 4.4.30). Kick-out rights allow partners to dissolve (liquidate) the partnership or otherwise remove the GP without cause.

Like a majority shareholder, an LP with the majority of kick-out rights is presumed to have the controlling financial interest in the partnership. However, control does not rest with the majority kick-out right holder if (see Question 5.2.10): [810-10-25-1A, 55-4V, 810-10 Glossary]

- NCI holder(s) has substantive participating rights that negate the power to control held by the majority kick-out right holder; or [810-10-25-5]
- another LP has the power to control the legal entity through other means. [810-10-15-8, 25-1]

Kick-out rights must be substantive to provide the majority kick-out right holder with a controlling financial interest. A substantive kick-out right provides the holder with the ability to exercise the right without significant barriers. [810-10-25-14A]

This section provides guidance on evaluating whether kick-out rights are substantive. The guidance on determining which party (if any) has the power to control a limited partnership that is a VOE also applies to legal entities that are similar to limited partnerships (see Question 5.2.140). [810-10-05-3, 25-14A – 25-14C]

Section 5.2.10 provides general guidance on the presumption of control by the majority holder (i.e. a majority shareholder or a majority kick-out right holder) and how that presumption is overcome. Section 5.3 provides guidance on evaluating whether participating rights are substantive. These sections also apply to evaluating which party (if any) has the power to control a limited partnership (or similar entity) that is a VOE.

Question 5.2.140

How does an enterprise evaluate whether a legal entity is similar to a limited partnership?

Interpretive response: The analysis of which enterprise has a controlling financial interest in a limited partnership differs from the analysis of which enterprise has a controlling financial interest in an entity that is not a limited partnership. The limited partnership analysis also applies to legal entities that are similar to limited partnerships. Therefore, it is important to determine whether a legal entity is similar to a limited partnership before an enterprise determines who consolidates the entity. [810-10-05-3]

A legal entity is similar to a limited partnership when it has "governing provisions that are the functional equivalent of a limited partnership." Functionally, a limited partnership is a legal entity "in which one or more GPs have unlimited liability and one or more partners have limited liability." [810-10-05-3, 810-10 Glossary]

A legal entity with governing provisions that are the functional equivalent of a limited partnership generally has a single investor that is responsible for managing the entity's operations. The delegation of operational authority to the managing investor is part of the agreement among all of the investors.

See Question 4.4.10 for additional guidance on how to evaluate whether a legal entity is similar to a limited partnership.

Question 5.2.150

Are liquidation rights considered kick-out rights in a limited partnership?

Interpretive response: Yes. In the context of the VOE consolidation model, liquidation rights provide their holders with the ability to dissolve the limited partnership, thereby effectively removing the decision-maker's authority.

See Question 4.4.150 for additional discussion about liquidation rights when determining whether a legal entity is a VIE, and Question 6.4.80 for guidance on evaluating liquidation rights when identifying the primary beneficiary of a VIE.

Question 5.2.160

Are redemption (withdrawal) rights considered kick-out rights in a limited partnership?

Interpretive response: Generally, no. Withdrawal rights that do not either explicitly or implicitly require dissolution or liquidation of the limited partnership are not considered similar to a substantive kick-out right. However, in rare situations withdrawal rights may implicitly require liquidation of a limited partnership and therefore function similarly to substantive kick-out rights.

See Questions 4.4.160 and 6.4.90 for additional guidance on determining whether a withdrawal right is equivalent to a kick-out right.

Question 5.2.170

What barriers may prevent kick-out rights from being substantive?

Interpretive response: Topic 810 does not provide specific examples of barriers to exercise. Therefore, all relevant facts and circumstances should be considered in evaluating whether there are barriers to exercising a right that makes it non-substantive.

In making this evaluation, the following factors may indicate that kick-out rights are not substantive: [810-10-25-14A]

- kick-out rights subject to conditions that make it unlikely they will be exercisable – e.g. conditions that narrowly limit the timing of the exercise or would be economically unfavorable for the party holding the rights;
- financial penalties or operational barriers associated with dissolving (liquidating) the VIE or replacing the decision-maker being kicked out, which could act as a significant disincentive for dissolution (liquidation) or removal;
- the absence of an adequate number of qualified replacement decision-makers or the lack of adequate compensation to attract a qualified replacement;
- the absence of an explicit, reasonable mechanism by which the party holding the rights can exercise those rights;
- the inability of the party holding the rights to obtain the information necessary to exercise them.

Further, barriers to exercise may be different for kick-out rights as compared with liquidation rights, which are evaluated in a similar manner to kick-out rights (see Question 5.2.150). The above factors are not exhaustive, and all relevant facts and circumstances should be considered in determining whether kick-out rights or liquidation rights are substantive.

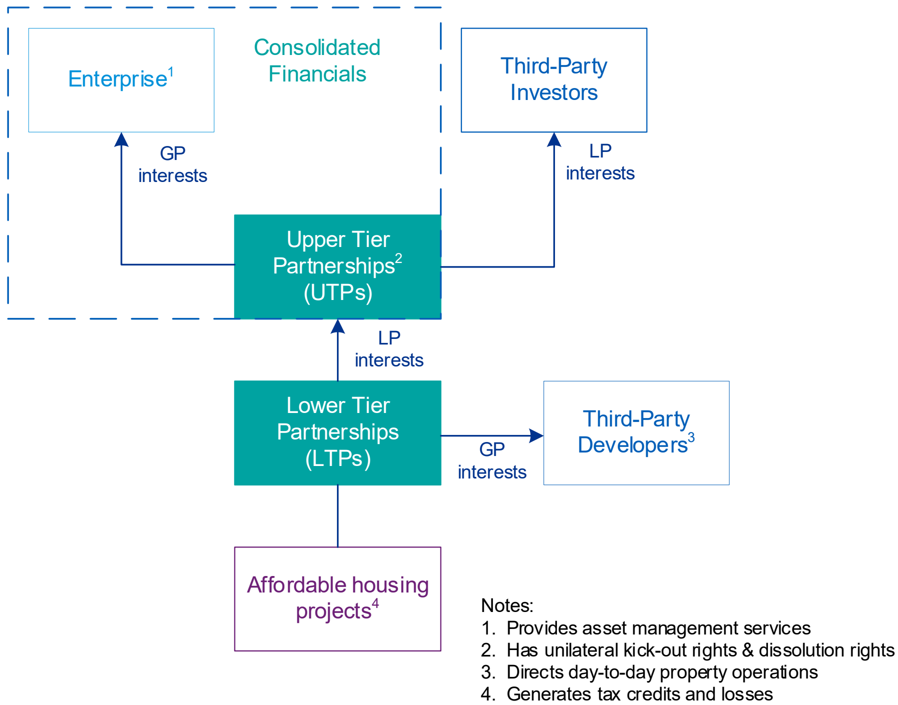
Example 5.2.60

Evaluating whether kick-out rights are substantive: business model and reputational risk

Background

Enterprise is a syndicator of affordable housing tax credits. Its tax credit syndication business model involves upper-tier partnerships (UTPs) that will make investments in lower-tier partnerships (LTPs). LTPs develop affordable housing projects to generate a stream of tax credits and losses.

The following diagram illustrates the structure.



As the GP of the UTPs, Enterprise provides asset management services and consolidates those UTPs. The GPs of the LTPs (third-party developers) are responsible for the construction and day-to-day operations of the properties and for ensuring the properties continue to qualify for tax credits.

In the LTPs, the LP (the UTP) has the contractual right to either unilaterally dissolve the LTP or to remove the GP (third-party developer) of the LTP without cause. However, in considering these rights:

— Enterprise (through UTP) has never exercised the right to remove a third-party developer of an LTP without cause;

— Enterprise (through UTP) has asserted that it would not exercise the right without cause because to do so would be inconsistent with its business model;

— if this provision were to be exercised, third-party developers would be less likely to enter into future LTPs with UTPs sponsored by Enterprise;

— Enterprise's relationships with third-party developers is critical to its business model; this is because the developers generally find the properties, perform all development activities and perform other critical elements for the LTPs; and

— the dissolution and removal rights would not exist but for statutory requirements.

The LTPs are VOEs because the UTPs have substantive participating rights and do not meet any of the other VIE characteristics (see section 4.2).

Evaluation

In this example, we believe Enterprise's kick-out right through the UTP over the GP of the LTP is non-substantive; this is because there are significant financial and operational barriers that act as a disincentive to Enterprise exercising that right through the UTP. As a result, Enterprise, through the UTP, does not have a controlling financial interest over the LTP, and does not consolidate the LTP.

In reaching this conclusion, the following are relevant.

— Arbitrary exercise of the kick-out (or dissolution) right would significantly affect Enterprise's ability to obtain future business. The developers rely on the potential profits to be made out of the residual sales of the properties and would be economically harmed if they were kicked out of a deal without cause.

— Further, the affordable housing investment market is a relatively small, niche market. Enterprise relies heavily on relationships it has cultivated with various developers. Exercising the kick-out right through the UTP without cause would damage both those relationships and its reputation in the marketplace with other developers, thereby having a significant negative effect on its ability to enter into future partnership agreements with developers. This is supported by the fact that Enterprise has never exercised these rights without cause.

Question 5.2.180

Is a return-sharing provision a significant barrier to exercising a kick-out right?

Background: In some limited partnerships, the GP has a right to share in a portion of the return related to investments of the partnership. Although the GP can be removed by a single LP, the return-sharing provision allows the GP to retain the right to share in investments it selected before being removed.

Interpretive response: It depends. A return-sharing provision may represent a barrier to the removal of the GP if:

— the partnership is not designed to continue acquiring investments after removal of the GP;

— replacement of the GP would reduce the level of return to which the LPs would otherwise be entitled; or

— the return-sharing provision would make it more difficult to attract a replacement GP (who would be subject to the same provision in the event of removal) than it otherwise would be without the return-sharing provision.

Evaluating whether a barrier to exercising a kick-out right exists requires significant judgment, and all relevant facts and circumstances should be considered.

5.3 Effect of noncontrolling rights – participating rights

Excerpt from ASC 810-10

General

> The Effect of Noncontrolling Rights on Consolidation

25-2 Paragraph 810-10-15-10(a)(1)(iv) explains that, in some instances, the powers of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling shareholder or limited partner (referred to as noncontrolling rights). That paragraph also explains that, in paragraphs 810-10-25-2 through 25-14, the term *noncontrolling shareholder* refers to one or more noncontrolling shareholders and the terms *limited partner* and *general partner* refer to one or more limited or general partners. Paragraph 810-10-15-10(a)(1)(iv) explains that those noncontrolling rights may have little or no impact on the ability of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the investee's operations or assets, or, alternatively, those rights may be so restrictive as to call into question whether control rests with the majority owner.

25-3 The guidance in paragraphs 810-10-25-1 through 25-14 shall be applied in assessing the impact on consolidation of noncontrolling shareholder or limited partner approval or veto rights in both of the following circumstances:

a. Investments in which the investor has a majority voting interest in investees that are corporations or analogous entities (such as limited liability companies that have governing provisions that are the functional equivalent of regular corporations), or investments in which a limited partner has a majority of kick-out rights through voting interests in a limited partnership
b. Other circumstances in which legal entities would be consolidated in accordance with generally accepted accounting principles (GAAP), absent the existence of certain approval or veto rights held by noncontrolling shareholders or limited partners.

25-4 The guidance in paragraphs 810-10-25-2 through 25-14 on noncontrolling rights does not apply in either of the following situations:

a. Entities that, in accordance with GAAP, carry substantially all of their assets, including investments in controlled entities, at fair value with changes in value reported in a statement of net income or financial performance
b. Investments in **variable interest entities** (VIEs) (see the Variable Interest Entities Subsection of Section 810-10-15).

25-5 The assessment of whether the rights of a noncontrolling shareholder or limited partner should overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee is a matter of judgment that depends on facts and circumstances. The framework in which such facts and circumstances are judged shall be based on whether the noncontrolling rights, individually or in the aggregate, allow the noncontrolling shareholder or limited partner to effectively participate in certain significant financial and operating decisions of the investee that are made in the **ordinary course of business**. Effective participation means the ability to block significant decisions proposed by the investor who has a majority voting interest or the general partner. That is, control does not rest with the majority owner because the investor with the majority voting interest cannot cause the investee to take an action that is significant in the ordinary course of business if it has been vetoed by the noncontrolling shareholder. Similarly, for limited partnerships, control does not rest with the limited partner with the majority of kick-out rights through voting interests if the limited partner cannot cause the general partner to take an action that is significant in the ordinary course of business if it has been vetoed by other limited partners. This assessment of noncontrolling rights shall be made at the time a majority voting interest or a majority of kick-out rights through voting interests is obtained and shall be reassessed if there is a significant change to the terms or in the exercisability of the rights of the noncontrolling shareholder or limited partner.

25-6 All noncontrolling rights could be described as protective of the noncontrolling shareholder's or limited partner's investment in the investee, but some noncontrolling rights also allow the noncontrolling shareholder or limited partner to participate in determining certain significant financial and operating decisions of the investee that are made in the ordinary course of business (referred to as **participating rights**). Participation means the ability to block actions proposed by the investor that has a majority voting interest or the general partner. Thus, the investor with the majority voting interest or the general partner must have the agreement of the noncontrolling shareholder or limited partner to take certain actions. Participation does not mean the ability of the noncontrolling shareholder or limited partner to initiate actions.

25-7 Noncontrolling rights that are only protective in nature (referred to as **protective rights**) would not overcome the presumption that the owner of a majority voting interest or the limited partner with a majority of kick-out rights through voting interests shall consolidate its investee. Substantive noncontrolling rights that allow the noncontrolling shareholder or limited partner to effectively participate in certain significant financial and operating decisions of the investee that are made in the investee's ordinary course of business, although also protective of the noncontrolling shareholder's or limited partner's investment, shall overcome the presumption that the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests shall consolidate its investee.

25-8 For purposes of this Subsection, decisions made in the ordinary course of business are defined as decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out the entity's current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. The ordinary course of business definition would not include self-dealing transactions with controlling shareholders or limited partners.

25-9 The following guidance addresses considerations of noncontrolling shareholder or limited partner rights, specifically:

a. Protective rights
b. Participating rights
c. Factors to consider in evaluating whether noncontrolling rights are substantive participating rights.

>> Protective Rights

25-10 Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to block corporate or partnership actions would be considered protective rights and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. The following list is illustrative of the protective rights that often are provided to the noncontrolling shareholder or limited partner but is not all-inclusive:

a. Amendments to articles of incorporation or partnership agreements of the investee
b. Pricing on transactions between the owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests and the investee and related self-dealing transactions
c. Liquidation of the investee in the context of Topic 852 on reorganizations or a decision to cause the investee to enter bankruptcy or other receivership
d. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (noncontrolling rights relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances [see paragraphs 810-10-25-13 and 810-10-55-1])
e. Issuance or repurchase of equity interests.

>> Participating Rights

25-11 Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to effectively participate in either of the following corporate or partnership actions shall be considered substantive participating rights and would overcome the presumption that the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests shall consolidate its investee. The following list is illustrative of substantive participating rights, but is not necessarily all-inclusive:

a. Selecting, terminating, and setting the compensation of management responsible for implementing the investee's policies and procedures
b. Establishing operating and capital decisions of the investee, including budgets, in the ordinary course of business.

25-12 The rights noted in paragraph 810-10-25-11 are participating rights because, in the aggregate, the rights allow the noncontrolling shareholder or limited partner to effectively participate in certain significant financial and operating decisions that occur as part of the ordinary course of the investee's business and are significant factors in directing and carrying out the activities of the business. Individual rights, such as the right to veto the termination of management responsible for implementing the investee's policies and procedures, should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves. However, noncontrolling rights that appear to be participating rights but that by themselves are not substantive (see paragraphs 810-10-25-13 and 810-10-55-1) would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. The likelihood that the veto right will be exercised by the noncontrolling shareholder or limited partner should not be considered when assessing whether a noncontrolling right is a substantive participating right.

>> Factors Consider in Evaluating Whether Noncontrolling Rights Are Substantive Participating Rights

25-13 The following factors shall be considered in evaluating whether noncontrolling rights that appear to be participating are substantive rights, that is, whether these factors provide for effective participation in certain significant financial and operating decisions that are made in the investee's ordinary course of business:

a. Consideration shall be given to situations in which a majority shareholder or limited partner with a majority of kick-out rights through voting interests owns such a significant portion of the investee that the noncontrolling shareholder or limited partner has a small economic interest. As the disparity between the ownership interest of majority and noncontrolling shareholders or between the limited partner with a majority of kick-out rights through voting interests and noncontrolling limited partners increases, the rights of the noncontrolling shareholder or limited partner are presumptively more likely to be protective rights and shall raise the level of skepticism about the substance of the right. Similarly, although a majority owner is presumed to control an investee, the level of skepticism about such ability shall increase as the investor's or limited partner's economic interest in the investee decreases.
b. The governing documents shall be considered to determine at what level decisions are made—at the shareholder or limited partner level or at the board level—and the rights at each level also shall be considered. In all situations, any matters that can be put to a vote of the shareholders or limited partners shall be considered to determine if other investors, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a shareholder or limited partner vote.
c. Relationships between the majority and noncontrolling shareholders or partners (other than an investment in the common investee) that are of a related-party nature, as defined in Topic 850, shall be considered in determining whether the participating rights of the noncontrolling shareholder or limited partner are substantive. For example, if the

noncontrolling shareholder or limited partner in an investee is a member of the immediate family of the majority shareholder, general partner, or limited partner with a majority of kick-out rights through voting interests of the investee, then the rights of the noncontrolling shareholder or limited partner likely would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee.

d. Certain noncontrolling rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the investee. Noncontrolling rights related to decisions that are not considered significant for directing and carrying out the activities of the investee's business are not substantive participating rights and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. Examples of such noncontrolling rights include all of the following:

    1. Location of the investee's headquarters
    2. Name of the investee
    3. Selection of auditors
    4. Selection of accounting principles for purposes of separate reporting of the investee's operations.

e. Certain noncontrolling rights may provide for the noncontrolling shareholder or limited partner to participate in certain significant financial and operating decisions that are made in the investee's ordinary course of business; however, the existence of such noncontrolling rights shall not overcome the presumption that the majority owner shall consolidate, if it is remote that the event or transaction that requires noncontrolling shareholder or limited partner approval will occur. Remote is defined in Topic 450 as the chance of the future event or events occurring being slight.

f. An owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests who has a contractual right to buy out the interest of the noncontrolling shareholder or limited partner in the investee for fair value or less shall consider the feasibility of exercising that contractual right when determining if the participating rights of the noncontrolling shareholder or limited partner are substantive. If such a buyout is prudent, feasible, and substantially within the control of the majority owner, the contractual right to buy out the noncontrolling owner or limited partner demonstrates that the participating right of the noncontrolling shareholder or limited partner is not a substantive right. The existence of such call options, for purposes of the General Subsections, negates the participating rights of the noncontrolling shareholder or limited partner to veto an action of the majority shareholder or general partner, rather than create an additional ownership interest for that majority shareholder. It would not be prudent, feasible, and substantially within the control of the majority owner to buy out the noncontrolling shareholder or limited partner if, for example, either of the following conditions exists:

    1. The noncontrolling shareholder or limited partner controls technology that is critical to the investee.

2. The noncontrolling shareholder or limited partner is the principal source of funding for the investee.

Paragraph 810-10-55-1 provides additional guidance on assessing substantive participating rights.

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

General

> Implementation Guidance

>> Assessing Individual Noncontrolling Rights

55-1 Examples of how to assess individual noncontrolling rights facilitate the understanding of how to assess whether the rights of the noncontrolling shareholder or limited partner should be considered protective or participating and, if participating, whether the rights are substantive. An assessment is relevant for determining whether noncontrolling rights overcome the presumption of control by the majority shareholder or limited partner with a majority of **kick-out rights** through voting interests in an entity under the General Subsections of this Subtopic. Although the following examples illustrate the assessment of **participating rights** or **protective rights**, the evaluation should consider all of the factors identified in paragraph 810-10-25-13 to determine whether the noncontrolling rights, individually or in the aggregate, provide for the holders of those rights to effectively participate in certain significant financial and operating decisions that are made in the **ordinary course of business**:

a. The rights of the noncontrolling shareholder or limited partner relating to the approval of acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business may be substantive participating rights. Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of the investee's existing business usually are protective and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. Whether a right to approve the acquisition or disposition of assets is in the ordinary course of business should be based on an evaluation of the relevant facts and circumstances. In addition, if approval by the shareholder or limited partner is necessary to incur additional indebtedness to finance an acquisition that is not in the investee's ordinary course of business, then the approval by the noncontrolling shareholder or limited partner would be considered a protective right.
b. Existing facts and circumstances should be considered in assessing whether the rights of the noncontrolling shareholder or limited partner relating to an investee's incurring additional indebtedness are protective or participating rights. For example, if it is reasonably possible or probable that

the investee will need to incur the level of borrowings that requires noncontrolling shareholder or limited partner approval in its ordinary course of business, the rights of the noncontrolling shareholder or limited partner would be viewed as substantive participating rights.

c. The rights of the noncontrolling shareholder or limited partner relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions would be protective rights.

d. The rights of the noncontrolling shareholder or limited partner relating to an investee's specific action (for example, to lease property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if the investee had the ability to purchase, rather than lease, the property without requiring approval of the noncontrolling shareholder or limited partner, then the rights of the noncontrolling shareholder or limited partner to block the investee from entering into a lease would not be substantive.

e. The rights of the noncontrolling shareholder or limited partner relating to an investee's negotiation of collective bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if an investee does not have a collective bargaining agreement with a union or if the union does not represent a substantial portion of the investee's work force, then the rights of the noncontrolling shareholder or limited partner to approve or veto a new or broader collective bargaining agreement are not substantive.

f. Provisions that govern what will occur if the noncontrolling shareholder or limited partner blocks the action of an **owner** of a majority voting interest or general partner need to be considered to determine whether the right of the noncontrolling shareholder or limited partner to block the action has substance. For example, if the shareholder or partnership agreement provides that if the noncontrolling shareholder or limited partner blocks the approval of an operating budget, then the budget simply defaults to last year's budget adjusted for inflation, and if the investee is a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights of the noncontrolling shareholder or limited partner to block the approval of the operating budget do not allow the noncontrolling shareholder or limited partner to effectively participate and are not substantive.

g. Noncontrolling rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances. For example, if lawsuits are a part of the entity's ordinary course of business, as is the case for some patent-holding companies and other entities, then the noncontrolling rights may be considered substantive participating rights.

h. A noncontrolling shareholder or limited partner has the right to veto the annual operating budget for the first X years of the relationship. Based on the facts and circumstances, during the first X years of the relationship this right may be a substantive participating right. However, following Year X there is a significant change in the exercisability of the noncontrolling right (for example, the veto right terminates). As of the beginning of the period following Year X, that right would no longer be a substantive participating right and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee.

Assessing the impact of noncontrolling rights on the majority holder (a majority shareholder or a majority kick-out right holder) and its ability to control an entity requires judgment.

Noncontrolling rights may: [810-10-15-8, 25-2 – 25-5]

— overcome the presumption of control by the majority holder if they are participating rights;
— have no effect on the presumption of control by the majority holder if they are only protective rights; or
— convey control to a single minority holder if that minority holder is able to control the decisions made in the ordinary course of business.

The following table describes participating rights and protective rights. [810-10-25-5, 25-8]

Participating rights	Rights that provide a noncontrolling holder with the ability to effectively participate in decisions made in the ordinary course of business. Effective participation by a noncontrolling holder overcomes the presumption of consolidation by the majority holder.
Protective rights	Rights that only serve to protect the noncontrolling holder's investment by allowing the holder to participate in decisions that are not made in the ordinary course of business. Protective rights do not overcome the presumption of consolidation by the majority holder.

The assessment of a noncontrolling right is made at the time the right is acquired and is reassessed if there is a change in its terms or exercisability. [810-10-25-6 – 25-7, 25-9 – 25-10]

Question 5.3.10
When are noncontrolling rights participating rights vs protective rights?

Interpretive response: Substantive participating rights are noncontrolling rights granted (by contract or law) that allow the NCI holder(s) to effectively participate in certain significant financial and operating decisions that occur as part of the legal entity's ordinary course of business.

Such decisions are further defined as follows. [810-10-25-8, 25-12]

Decisions made in the ordinary course of business	Decisions about matters normally expected to be addressed in directing and carrying out the entity's current business activities.

Additional considerations
— It must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur.   — Whether the events or transactions that would necessitate such decisions are expected to occur in the near term is irrelevant.   — The ordinary course of business definition does not include self-dealing transactions with controlling shareholders or LPs.

Participation means that the NCI holder(s) can block actions proposed by the majority holder. A substantive participating right need not give the NCI holder(s) the ability to initiate actions (see Question 5.3.70). [810-10-25-6]

Subtopic 810-10 provides the following examples of substantive participating rights under the above framework: [810-10-25-11]

— the right to select, terminate and set the compensation of management responsible for implementing the legal entity's policies and procedures; and
— the right to establish the legal entity's operating and capital decisions, including budgets, in the ordinary course of business.

While each of these two collections of noncontrolling rights are presumed to be substantive participating rights, an enterprise needs to evaluate other noncontrolling rights, whether or not included in the above list, to determine if they are participating or protective rights. For example, if an enterprise has the right to set the compensation of management, but cannot select or terminate management, all facts and circumstances should be considered when evaluating whether this is a substantive participating right on its own. [810-10-25-12]

In contrast to participating rights, protective rights allow the NCI holder(s) to block corporate or partnership actions that do not occur in the ordinary course of business. They serve only to protect the investment of the NCI holder(s).

A key factor in evaluating noncontrolling rights, as illustrated below, is whether the rights provide the NCI holder(s) the ability to participate in decisions made in the ordinary course of business. Therefore, a similar right could be a participating right for one entity, and a protective right for another entity, as what constitutes 'ordinary course' can be different across different entities.

The following table provides insights into whether certain common noncontrolling rights are participating or protective in nature. [810-10-55-1]

Noncontrolling right allows NCI holder(s) to:		**Participating or protective?**
Approve acquisitions and dispositions of assets (see Question 5.3.30) [810-10-55-1(a)]	expected to be undertaken in the ordinary course of business	Participating
	not expected to be undertaken in the ordinary course of the existing business	Usually protective

Noncontrolling right allows NCI holder(s) to:		Participating or protective?
Approve incurring additional indebtedness [810-10-55-1(b)]	expected to be undertaken in the ordinary course of business	Participating
	not expected to be undertaken in the ordinary course of the existing business	Protective
Block dividends and other distributions [810-10-55-1(c)]	customary/expected dividends or other distributions	Participating
	extraordinary distributions	Protective
Initiate or resolve lawsuits [810-10-55-1(d)]	expected in the ordinary course of business	Participating
	not expected in the ordinary course of business	Protective
Approve specific action in the legal entity's existing business – e.g. approve leases [810-10-55-1(d)]	expected in ordinary course/existing business requires approval, and approval is substantive	Participating
	not expected in the ordinary course of business, or approval can be circumvented – e.g. NCI holder(s) must approve a property lease, but the legal entity has the ability to purchase the same property without approval, and therefore can circumvent the need for lease approval	Protective
Approve the legal entity's negotiation of collective bargaining agreements with unions [810-10-55-1(e)]	expected in the ordinary course of business	Participating
	not expected in the ordinary course of business – e.g. legal entity does not have a collective bargaining agreement with a union, or the union does not represent a substantial portion of the workforce	Protective

Another consideration is whether a noncontrolling right is substantive. In making this determination, it is important to consider the provisions that govern what will occur when the NCI holder(s) exercises its right. For example, the governing documents of an investee may indicate that if the NCI holder(s) exercises its right to block the approval of the investee's operating budget, the budget simply defaults to last year's budget adjusted for inflation. If the investee is a mature business for which year-to-year operating budgets are not expected to vary significantly, this right does not allow the NCI holder(s) to effectively participate and therefore is not substantive. [810-10-55-1(f)]

Question 4.4.90 provides guidance on what may constitute substantive participating rights in a mutual fund when determining whether the fund is a

VIE. Although that guidance is provided in the context of evaluating substantive participating rights using the VIE definition, it may be useful in evaluating similar rights in a VOE.

Question 5.3.20

Must the NCI holder(s) actively exercise its participating right for the right to be substantive?

Interpretive response: No. The NCI holder(s) effectively participates when it has the ability to block significant decisions made by the majority holder in the ordinary course of the VOE's business. Past practice or intent to exercise noncontrolling rights is not considered when assessing whether the rights are substantive participating rights. [810-10-25-5 – 25-6, 25-12]

For example, even if the NCI holder(s) has always voted to support the majority holder, and has commercial reasons to continue to do so, that fact would not affect the analysis of whether participating rights are substantive.

Question 5.3.30

When is the right to approve acquisitions and dispositions a participating right?

Interpretive response: The right of the NCI holder(s) to approve acquisitions and dispositions is a substantive participating right when those transactions are expected to occur in the ordinary course of the VOE's business. In contrast, the approval right is typically a protective right when (1) those transactions are not expected to occur in the ordinary course of business or (2) the right applies only to acquisitions or dispositions, but not both.

The agreement giving an NCI the right to approve acquisitions and dispositions typically won't expressly indicate if the right applies only to acquisitions and dispositions outside the ordinary course of business. So, an enterprise must determine if such a right is participating or protective based on all relevant facts and circumstances. The conclusion may differ depending on the nature and extent of the legal entity's assets and operations.

EITF 96-16 (noncontrolling shareholder approval or veto rights) originally contained guidance indicating that the right to approve acquisitions and dispositions is protective if it related only to transactions that exceed 20% of the legal entity's total assets. That 20% threshold was subsequently removed from subsequent consolidation guidance to avoid its literal application as a bright line rule. Nevertheless, we believe that under certain circumstances the right to approve acquisitions and dispositions of assets exceeding 20% of the fair value of the total assets may be a protective right when a VOE has numerous assets and extensive operations.

In contrast, if the VOE has limited operations and only a few assets (e.g. a real estate partnership with a limited number of properties), the right to approve acquisitions and dispositions of assets exceeding the 20% threshold may be a substantive participating right. The relevant consideration is whether the approval right pertains to the ordinary course of the legal entity's business (see Question 5.3.10).

Note: The change to eliminate the 20% threshold in EITF 96-16 was applied prospectively. Therefore, the 20% threshold applies to consolidation conclusions made for investments and investment agreements entered into before June 29, 2005.

Question 5.3.40

Are there other factors to consider when evaluating whether participating rights are substantive?

Interpretive response: Yes. The rights of the NCI holder(s) should allow the holder(s) to effectively participate in the legal entity's ongoing day-to-day activities for those rights to be considered substantive participating rights. [810-10-25-12]

Beyond analyzing the nature of the rights themselves (see Question 5.3.10), an enterprise should also consider the following factors in when evaluating whether participating rights are substantive. [810-10-25-13 – 25-14]

Disparity in ownership percentage between NCI holder(s) and majority holder	As the majority holder's ownership percentage increases (and that of the NCI holder(s) decreases) the presumption of control generally grows stronger. The greater the disparity between the ownership percentages of the majority and NCI holder(s), the greater the likelihood that noncontrolling rights are protective instead of participating.
The **decision-making processes** as discussed in the governing documents	VOEs may have varying levels of decision-making – e.g. some decisions may be made by a board of directors and some may be made by shareholder/LP vote. It is important to understand at what level decisions are made and the rights at each level. Only rights that allow the NCI holder(s) to effectively participate in decisions in the ordinary course of business are substantive participating rights. See Question 5.2.90 for guidance on how a minority holder's right to control the board affects the control analysis.
Existence of **related party relationships** between the majority holder and NCI holder(s)	Certain related party relationships under Topic 850 (related parties) between the majority and NCI holder(s) may suggest that participating rights are not substantive. For example, noncontrolling rights held by the NCI holder(s) that is under common control with the majority holder may not be substantive. See Question 3.8.230 for discussion of common control.

Participation limited to decisions that are not significant to carrying out business activities, or based on events whose chance of occurrence is remote	Noncontrolling rights that allow the NCI holder(s) to participate in decisions that are insignificant to the ordinary course of business are not substantive participating rights – e.g. the name of the VOE, the location of its headquarters, and the selection of its auditors or accounting principles. Further, if the likelihood that the events or transactions that require NCI approval is remote, the noncontrolling right is not a substantive participating right.
The **ability of the majority holder to buy out** the NCI holder(s) at an amount ≤ fair value	An NCI holder's participating right may not be substantive if the majority holder has the right to buy out the NCI holder's interest at a price of fair value or less. In this case, the enterprise must evaluate the feasibility of exercising this buyout right to determine whether the participating right is substantive (see Question 5.3.50).

Although not addressed in the general subsections of Subtopic 810-10, we believe a participating right generally would be exercisable by a simple majority of the NCI holder(s) to be 'substantive' (see section 4.4.30) under the VOE consolidation model.

Question 5.3.50

When does a buyout provision make participating rights non-substantive?

Interpretive response: A buyout that is prudent, feasible and substantially within the majority holder's control generally results in an NCI holder's participating rights being non-substantive. [810-10-25-13(f)]

A buyout right is not prudent, feasible and substantially within the majority holder's control if the NCI holder(s) either: [810-10-25-13(f)]

— controls technology that is critical to the VOE; or
— is the principal source of funding to the VOE.

In addition, a buyout provision that has a purchase price in excess of fair value typically is not prudent and feasible for a majority holder to exercise. Because the exercise price may be tied to the VOE's profits or cash flows (versus being set specifically to fair value or a fixed price below fair value), it may be unclear whether that price is at or below fair value.

We believe that a buyout right at a price of fair value does not automatically make an NCI holder's participating right non-substantive. As discussed in Question 5.3.40, a majority holder with a buyout right at a price of fair value (or less) must consider whether the buyout is prudent, feasible and substantially within its control. Judgment and consideration of all the facts are essential to evaluating the impact of a buyout right on participating rights. See Question 5.3.60 for additional discussion.

Example 5.3.10
Protective right: event of default

Background

Enterprise enters into a business combination in which it acquires all of the outstanding shares of Legal Entity in exchange for cash, stock and a promissory note.

The promissory note is collateralized by the shares of Legal Entity allowing the former shareholders of Legal Entity, now employees of Enterprise, to have a security interest until the promissory note is paid.

If Enterprise breaches certain covenants, the promissory note defaults and becomes immediately payable. In the event of a default, if Enterprise is unable to repay the remaining balance on the promissory note, the former shareholders of Legal Entity can vote Enterprise's shares of Legal Entity. Further, until the notes are paid, Enterprise may not take distributions from Legal Entity and the former shareholders have approval rights over operating decisions that are made in the ordinary course of business.

Enterprise may prepay the notes at any time and has the ability to do so.

Evaluation

The participating rights retained by the former shareholders are non-substantive. This is because settling the promissory note, and therefore removing the former shareholders' participating rights, is prudent, feasible and within Enterprise's control. As a result, Enterprise consolidates Legal Entity.

Question 5.3.60
Does a buy-sell dispute mechanism make a participating right non-substantive?

Background: In some limited partnerships and other similar structures, the governing documents require the LP and the GP to either agree on the partnership's operating budget or a buy-sell dispute mechanism is triggered. Under the buy-sell, the LP (the party with participating rights) has the right to establish a price at which the GP must either:

— purchase the LP's interest; or
— sell its GP interest to the LP.

These buy-sell provisions may also exist between a majority holder (evaluated like the GP) and minority holder (evaluated like the LP).

Interpretive response: It depends. A buy-sell dispute resolution provision provides the LP the following choices if it disputes the budget:

— accept the decisions of the GP;
— dispose of its LP interest; or
— acquire the GP's interest.

As discussed in Question 5.3.50, a buyout right held by a majority holder (or GP) results in a minority holder's participating right being non-substantive if the buyout is prudent, feasible and substantially within the majority holder's (GP's) control.

The following considerations may be relevant in the analysis. However, all facts and circumstances should be evaluated.

— Some buy-sell provisions give the GP the right to reject the LP's offer to buy the GP's interest if the buy-sell is triggered. In that case, the buy-sell is substantively a buyout right that is substantially within the GP's control. As a result, the LP's participating right is not substantive if the GP's buyout right is prudent and feasible.

— If the LP does not have the financial ability to acquire the GP's interest (or if other barriers to acquisition exist; see Question 5.2.170), the buy-sell is substantively a buyout right that is substantially within the GP's control. As a result, the LP's participating right is not substantive if the GP's buyout right is prudent and feasible.

— A GP's buyout right may not be prudent if the purchase price is in excess of fair value. As discussed in Question 5.3.50, because the purchase price may be tied to the partnership's profits or cash flows (versus being set specifically to fair value or a fixed price below fair value), it may be unclear whether that price is at, above or below fair value. The LP's participating right is generally substantive if the GP's buyout right is not prudent.

— If the GP does not have the financial ability to acquire the LP's interest (or if other barriers to acquisition exist), the buy-sell may be like a unilateral kick-out right held by the LP. In that case, the LP may have the power to control (see section 5.2) if the kick-out right is substantive, which is more likely if the GP's economic interest is minor.

Although this guidance broadly applies to buy-sell provisions in the context of determining whether the NCI holder(s) has substantive participating rights, (which overcome the presumption of control by the majority holder), it also applies when evaluating:

— whether the LPs have substantive participating or kick-out rights over a GP in the context of determining whether a partnership (or similar entity) is a VIE (see section 4.4.30); and

— whether a single party has substantive participating or kick-out rights over a decision-maker in the context of determining the primary beneficiary of a partnership (or similar entity) that is a VIE (see section 6.4).

Although buy-sell dispute mechanisms typically arise in partnerships or similar entities, they may also exist in other entities – e.g. corporations or LLCs that are similar to corporations. Regardless of the type of entity, a buy-sell dispute mechanism should be carefully evaluated to determine its impact on participating rights. If the buyout is not prudent, feasible and substantially within the majority holder's control, it has no impact when evaluating whether an NCI holder's participating right is substantive. The SEC staff has emphasized the importance of this analysis when analyzing the effect of a buyout provision.
[2020 AICPA Conf]

Question 5.3.70

Does an enterprise with substantive participating rights have the power control a VOE?

Interpretive response: Not necessarily. Participating rights often do not provide their holder with the right to propose decisions or to unilaterally make decisions. Instead, they generally provide their holder with the right to approve decisions that are proposed by the majority holder. Participating rights generally require at least two independent parties to agree to specified decisions that are made about an entity's activities. As a result, unlike a holder of a unilateral kick-out right (see section 5.2), a holder of substantive participating rights may not have the power to control a VOE.

However, all facts and circumstances should be considered. Some rights that appear to be participating rights instead convey the right to make decisions resulting in control of the VOE (see Example 5.3.20) and some may substantively be kick-out rights (see Question 5.3.60).

Example 5.3.20

Substantive participating right: purchase option

Background

Enterprise sold a 25% interest in a Legal Entity (a previously wholly owned subsidiary that is a VOE) to Buyer. Under the terms of the arrangement:

— Buyer may, at its option, purchase an additional 25% interest in Legal Entity at any time over the next three years ('option period');
— Buyer is named 'managing shareholder' for the duration of the option period;
— Enterprise retained certain protective rights over the sale and/or liquidation of Legal Entity; and
— if Buyer has not exercised the purchase option at the end of the option period, Enterprise becomes the managing shareholder.

As managing shareholder during the option period, Buyer is responsible for day-to-day operating decisions of the subsidiary, including the:

— preparation of budgets, and
— selection of management.

Evaluation

The responsibilities and rights granted to Buyer as the managing shareholder (i.e. preparation of budgets and selection of management) convey to the Buyer the power to control Legal Entity.

We believe that Enterprise should deconsolidate Legal Entity on the closing of the sale and execution of the arrangement.

If, at the end of the three-year period, Buyer has not exercised the purchase option, Enterprise should consolidate Legal Entity (see Question 5.2.20).

6. Who consolidates a VIE?

Detailed contents

New item added in this edition: **

Questions

6.3.10	What is the process for identifying the most significant activities?
6.3.20	What factors does an enterprise consider when identifying activities impacting the economic performance of a VIE?
6.3.30	Must an enterprise identify a single activity that most significantly affects economic performance?
6.3.40	What is the process for identifying the activities that most significantly impact a VIE's economic performance?
6.3.50	Are the activities that most significantly impact an entity's economic performance the same when evaluating whether an entity is a VIE and determining the primary beneficiary?
6.3.60	How has the SEC staff analyzed the activities that most significantly impact a VIE?
6.3.70	Is it possible for a VIE not to have any activities that significantly impact its economic performance?
6.3.80	In a trust preferred structure, which party has the power to direct the most significant activities?
6.3.90	Are the activities that convey power limited to those that create the variability absorbed by the equity-at-risk group?
6.3.100	When a VIE's significant activities occur outside of the VIE, are they relevant to evaluating the power criterion?
6.3.110	What is the process for determining which party has power over the activities that most significantly impact a VIE's economic performance?
6.3.120	Does the party that meets the power criterion typically direct the activities that create the VIE's variability?
6.3.130	Can an enterprise identify a party with power if it cannot link the VIE's risks with specific activities?
6.3.140	Does an enterprise automatically meet the power criterion if is significantly involved in a VIE's activities and operations?
6.3.150	If an enterprise doesn't plan to exercise its power, can it still meet the power criterion?
6.3.160	How is the power criterion affected if an enterprise obtains power upon the occurrence of a specified event or circumstance?
6.3.170	How is the power criterion affected if an enterprise directs only default mitigation activities if default occurs?
6.3.180	Does a contingent protective right impact the power criterion?
6.3.190	How is a protective right distinguished from contingent power?

Examples

Questions

Examples

6.7 Primary beneficiary reconsideration

Questions

Example

6.8 FASB examples

6.1 How the standard works

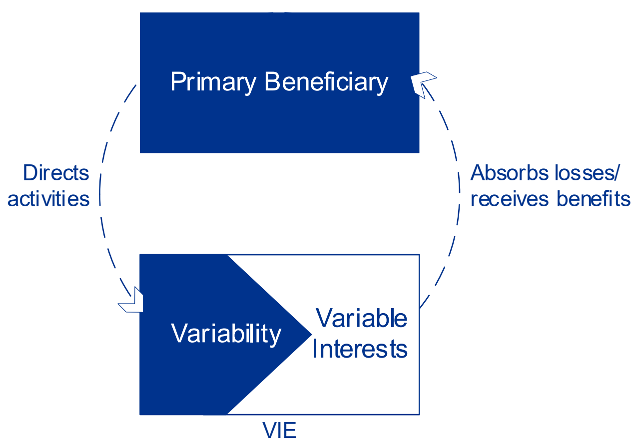
The enterprise that holds a controlling financial interest in a VIE is the primary beneficiary and consolidates the VIE.

An enterprise has a controlling financial interest if it has power over the legal entity and an economic interest in the entity. The power concept for determining the primary beneficiary under the VIE consolidation model differs from the majority-voting-control concept under the VOE consolidation model.

Under the VIE consolidation model, identifying the primary beneficiary requires a qualitative approach.

The **qualitative approach** to identifying the **primary beneficiary**	...**power over** the **activities** that **most significantly impact** a VIE's **economic performance...**
	...when the **power** is **held by a party** with an **economic interest** that is **significant** to the VIE

The primary beneficiary both directs the activities that most significantly impact variability and has a variable interest that absorbs variability that could potentially be significant to the VIE. This is illustrated in the following diagram.

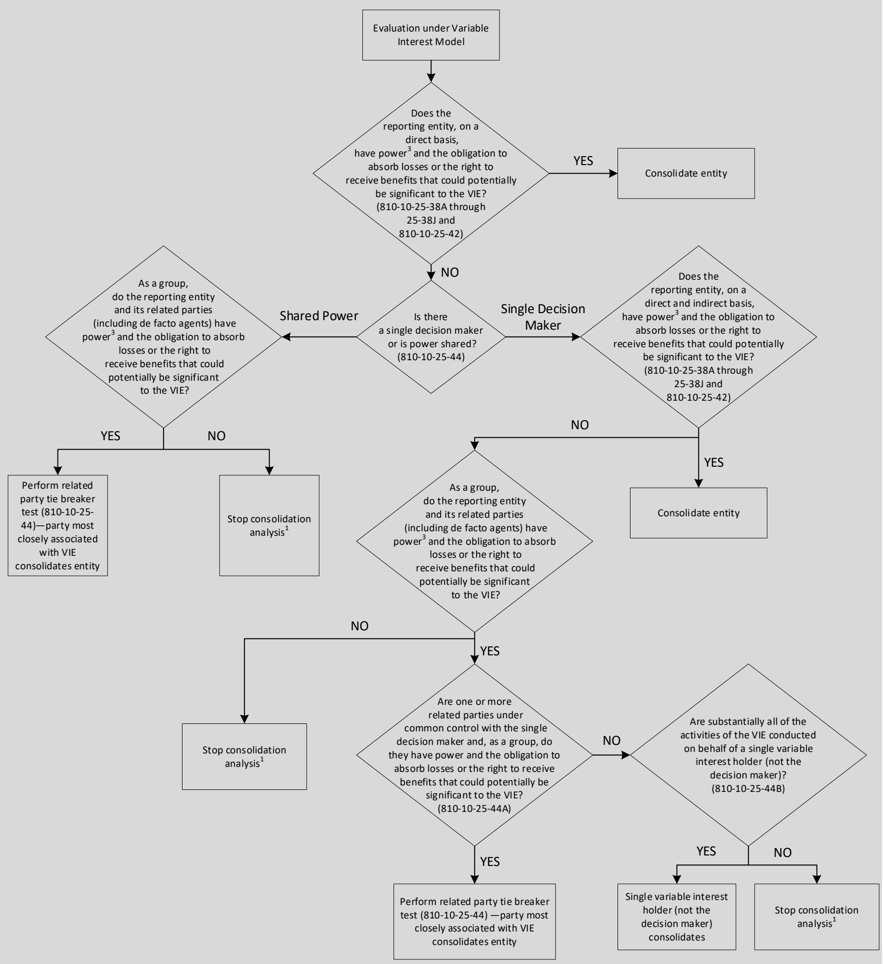


6.2 Overview of the primary beneficiary analysis

Excerpt from ASC 810-10

General

05-6 The following flowchart provides an overview of the guidance in this Subtopic for evaluating whether a reporting entity should consolidate another legal entity. The flowchart does not include all of the guidance in this Subtopic and is not intended as a substitute for the guidance in this Subtopic. For example, the flowchart does not illustrate the consolidation analysis for entities controlled by contract.



[1]Consolidation is not required; however, evaluation of other generally accepted accounting principles (GAAP) may be relevant to determine recognition, measurement, or disclosure.
[3]Power is defined as the power to direct the activities of a VIE that most significantly impact the VIE's economic performance.

Variable Interest Entities

> Consolidation of VIEs

05-8 The Variable Interest Entities Subsections clarify the application of the General Subsections to certain legal entities in which equity investors do not have sufficient equity at risk for the legal entity to finance its activities without additional subordinated financial support or, as a group, the holders of the equity investment at risk lack any one of the following three characteristics:

a. 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
b. The obligation to absorb the expected losses of the legal entity
c. The right to receive the expected residual returns of the legal entity.

Paragraph 810-10-10-1 states that consolidated financial statements are usually necessary for a fair presentation if one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities. For legal entities other than limited partnerships, paragraph 810-10-15-8 states that the usual condition for a controlling financial interest is ownership of a majority voting interest. For limited partnerships, paragraph 810-10-15-8A states that the usual condition for a controlling financial interest is ownership of a majority of the limited partnership's kick-out rights through voting interests. However, application of the majority voting interest and kick-out rights requirements in the General Subsections of this Subtopic to certain types of entities may not identify the party with a controlling financial interest because the controlling financial interest may be achieved through arrangements that do not involve voting interests or kick-out rights.

> Consolidation Based on Variable Interests

25-38 A reporting entity shall consolidate a VIE when that reporting entity has a variable interest (or combination of variable interests) that provides the reporting entity with a controlling financial interest on the basis of the provisions in paragraphs 810-10-25-38A through 25-38J. The reporting entity that consolidates a VIE is called the primary beneficiary of that VIE.

25-38A A reporting entity with a variable interest in a VIE shall assess whether the reporting entity has a controlling financial interest in the VIE and, thus, is the VIE's primary beneficiary. This shall include an assessment of the characteristics of the reporting entity's variable interest(s) and other involvements (including involvement of related parties and de facto agents), if any, in the VIE, as well as the involvement of other variable interest holders. Paragraph 810-10-25-43 provides guidance on related parties and de facto agents. Additionally, the assessment shall consider the VIE's purpose and design, including the risks that the VIE was designed to create and pass through to its variable interest holders. A reporting entity shall be deemed to have a controlling financial interest in a VIE if it has both of the following characteristics:

a. The power to direct the activities of a VIE that most significantly impact the VIE's economic performance
b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The quantitative approach described in the definitions of the terms **expected losses**, **expected residual returns**, and **expected variability** is not required and shall not be the sole determinant as to whether a reporting entity has these obligations or rights.

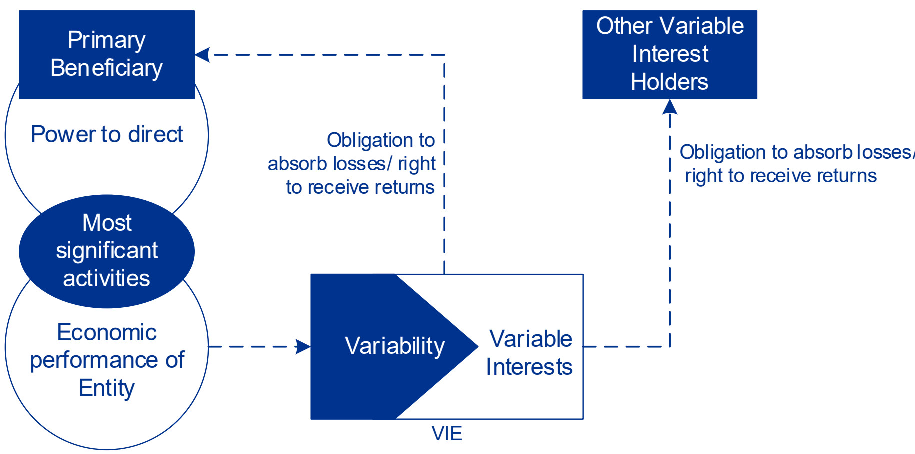
Only one reporting entity, if any, is expected to be identified as the primary beneficiary of a VIE. Although more than one reporting entity could have the characteristic in (b) of this paragraph, only one reporting entity if any, will have the power to direct the activities of a VIE that most significantly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

A VIE's primary beneficiary is the party that consolidates the VIE. The primary beneficiary is the variable interest holder that has a controlling financial interest in the VIE. [810-10-25-38]

A variable interest holder has a controlling financial interest in a VIE if it meets both of the following criteria (the 'primary beneficiary' criteria). [810-10-25-38A]

— Power to direct the most significant activities. The variable interest holder has the power to direct the activities that most significantly impact the VIE's economic performance. This is referred to in this publication as the power criterion.

— Potentially significant variable interest. The variable interest holder has the obligation to absorb losses of the VIE, or the right to receive benefits from the VIE, that could potentially be significant to the VIE. This is referred to in this publication as the significant variable interest criterion.



Multiple enterprises may meet the significant variable interest criterion, but only one enterprise can meet the power criterion. [810-10-25-38A(b)]

Question 6.2.10

How does an enterprise apply the primary beneficiary analysis?

Interpretive response: The following decision tree provides an overview of the primary beneficiary analysis. As a reminder, an enterprise must have a variable interest in the VIE to be its primary beneficiary (see Question 6.2.30).

As shown in the decision tree, there are four paths to consolidating a VIE:

— the enterprise meets the primary beneficiary criteria on its own considering its direct interests;

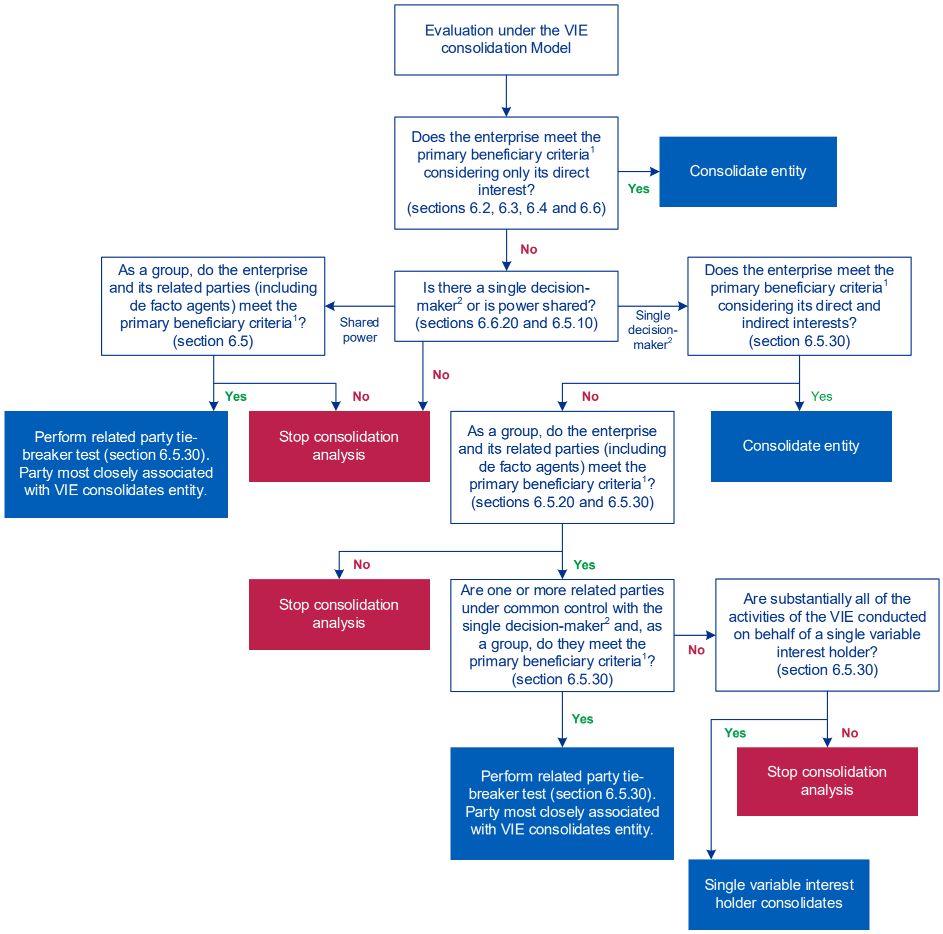
— the enterprise is a single decision-maker and it meets the primary beneficiary criteria on its own considering its direct and indirect interests;

— the enterprise is a single decision-maker and it meets the primary beneficiary criteria together with its related parties:

  – if the enterprise's fee is a variable interest and is under common control with one or more of its related parties, a tie-breaker test identifies which party consolidates; or

  – if the enterprise's fee is not a variable interest and there is no common control group, but substantially all activities of the VIE are conducted on behalf of another party in the enterprise's related party group, then that other party consolidates; or

— there is shared power by the enterprise and one or more of its related parties that collectively meet the primary beneficiary criteria; in that case, a tie-breaker test identifies which party should consolidate.



Notes:
1. Primary beneficiary criteria = the power criterion and the significant variable interest criterion
2. Single decision-maker = an enterprise that meets the power criterion on its own

Question 6.2.20

Does 'power' under the VIE consolidation model mean the same as 'control' under the VOE consolidation model?

Interpretive response: No. The concepts are similar and often result in the same conclusion about which party (if any) has a controlling financial interest in a legal entity. However, they do not have the same meaning. The following table illustrates the differences.

	VIE 'power' model	VOE 'control' model
Step 1	Identify activities and decisions that most significantly impact economic performance of the VIE.	N/A – this step is not performed.

	VIE 'power' model	VOE 'control' model
Step 2	Identify enterprise with power over these activities and decisions.	N/A – the enterprise that has control is presumed to have power over these activities and decisions.
Step 3	Enterprise with power meets the power criterion.	Enterprise with > 50% voting interest is presumed to control.

For VOEs, determining which enterprise controls a legal entity is generally a one-step process: identify the enterprise with greater than 50% voting ownership (or 50% of the kick-out rights if the legal entity is a partnership). That enterprise is presumed to have control unless the minority owners can participate in significant financial reporting and operating decisions of the legal entity that are made in the ordinary course of business (see chapter 5). [810-10-25-1 – 25-5]

For VIEs, an enterprise identifies the activities and decisions that most significantly impact the VIE's economic performance from the population of all activities and decisions that may affect the VIE. To be the primary beneficiary, an enterprise has to have the power over these specific activities; it need not have power over all of the VIE's activities. [810-10-25-38A(a)]

Question 6.2.30

Can an enterprise consolidate a VIE in which it does not have a variable interest?

Interpretive response: No. An enterprise cannot be the primary beneficiary of a VIE if it does not hold a variable interest in the entity. As a result, if an enterprise concludes that it does not have a variable interest in a VIE, it does not further evaluate that entity for consolidation or disclosure under Topic 810. [810-10-25-38]

Question 6.2.40

How do variable interests held by related parties affect the primary beneficiary determination?

Interpretive response: The effect of related party relationships on the primary beneficiary determination depends on whether there is a single decision-maker and whether the single decision-maker's fee is a variable interest. An enterprise is a single decision-maker if it individually has the power to direct the activities that most significantly impact the VIE's economic performance.

VIEs with a single decision-maker – fee is a variable interest

If a single decision-maker's fee is a variable interest, it usually also meets the significant variable interest criterion (see Question 6.6.150). If a single decision-maker meets the significant variable interest criterion and its fee is a variable interest, the single decision-maker is the primary beneficiary.

Conversely, if the single decision-maker's fee is a variable interest but it does not meet the significant variable interest criterion, the VIE may still have a primary beneficiary depending on the single decision-maker's related party relationships.

— If the single decision-maker is in a common control group (see Question 3.8.230) that meets the significant variable interest criterion, the party in the group that is most closely associated with the VIE is the primary beneficiary.

— If the single decision-maker is in a related party group whose members are not under common control and that group meets the significant variable interest criterion, the VIE has a primary beneficiary only if substantially all of its activities are conducted on behalf of another party in the single decision-maker's related party group.

Effect of related parties when evaluating the significant variable interest criterion

A single decision-maker must include its direct and indirect interests held through related parties in evaluating whether it meets the significant variable interest criterion. [810-10-25-42]

When computing its indirect interest in a VIE, a single decision-maker only considers its proportionate interest in the VIE held through related parties (see section 3.8.20.) If the single decision-maker does not hold an interest in a related party, it does not include the related party's variable interest when evaluating the significant variable interest criterion. [810-10-25-42]

VIEs with a single decision-maker – fee is not a variable interest

If a single decision-maker's fee is not a variable interest, the VIE has a primary beneficiary only if substantially all of its activities are conducted on behalf of another party in the single decision-maker's related party group. That other party is the primary beneficiary.

VIEs without a single decision-maker

If no individual party in a related party group meets both of the primary beneficiary criteria but the group collectively meets the criteria, further evaluation is needed to determine which party in the related party group should consolidate the VIE.

— If there is shared power within the related party group, the party with shared power that is most closely associated with the VIE is the primary beneficiary. The primary beneficiary must have a variable interest in the VIE.

— If there is not shared power within the related party group, the VIE has no primary beneficiary.

Section 6.5.10 discusses shared power. Section 6.5.30 contains further discussion of the consideration of related parties in determining the primary beneficiary of a VIE, and Question 6.5.180 includes a decision tree that illustrates this analysis.

Question 6.2.50

Is a quantitative approach required when determining whether an enterprise meets the significant variable interest criterion?

Interpretive response: No. To prevent quantitative tests from being exclusively used in the primary beneficiary determination, Topic 810 states that a quantitative approach should not be the sole determinant when evaluating an enterprise's obligations to absorb losses or right to receive benefits. [810-10-25-38A(b)]

While the use of quantitative analyses has been de-emphasized, they may be useful in certain situations. The concept of an enterprise's obligation to absorb losses or receive economic benefits is discussed in section 6.6, including how to use qualitative and quantitative analyses.

Question 6.2.60

If an enterprise has either an obligation to absorb losses or a right to receive benefits (but not both), is it precluded from being the primary beneficiary?

Interpretive response: No. To meet the significant variable interest criterion, the primary beneficiary is not required to have both the obligation to absorb losses and the right to receive benefits. It could be that the enterprise has one or the other, either of which could potentially be significant. [810-10-25-38A(b)]

For example, an enterprise is a VIE's primary beneficiary if it:

— meets the power criterion (see Question 6.2.20), and
— has the right to receive benefits that could potentially be significant to the VIE (causing it to meet the significant variable interest criterion)

It is not required that the enterprise also has the obligation to absorb any of the VIE's losses.

Question 6.2.70

Must the power to direct the most significant activities be conveyed through a variable interest?

Interpretive response: No. Although an enterprise must have a variable interest to be a VIE's primary beneficiary, it may possess the power to direct the most significant activities through other, non-variable interests. Therefore, an enterprise should consider all of its arrangements and interests in a VIE, including non-variable interests, when evaluating whether it is the VIE's primary beneficiary. Non-variable interests are included in the primary beneficiary determination so that an enterprise cannot structure an arrangement with a VIE to avoid consolidation.

For example, an enterprise may enter into a voting agreement with other shareholders of a VIE that entitles the enterprise to make decisions about the activities that most significantly impact the VIE's economic performance.

Notes:
1. Meets the power criterion
2. Meets the significant variable interest criterion

The voting agreement might not convey an obligation to absorb any of the entity's losses or a right to receive any of its benefits. However, if the enterprise has a separate variable interest (e.g. an equity investment) that meets the significant variable interest criterion, the enterprise is the VIE's primary beneficiary. The primary beneficiary criteria may be met through one arrangement (e.g. a fee-based or non-fee decision-maker arrangement; see section 6.6) the combination of an arrangement and an interest, multiple arrangements or multiple interests.

An enterprise must consider all potential sources of power when assessing the power criterion. This approach has been reinforced by the SEC staff (see below). [2010 AICPA Conf]

See Question 6.2.80 for additional guidance on how a decision-maker considers this guidance if its fee is not a variable interest.

Excerpt from SEC staff speech

The literature requires reporting entities to incorporate all sources of power into the analysis, which may be embedded in various arrangements and at various levels within the entity's structure. For example, it 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.

Wesley R. Bricker, Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments

Question 6.2.80

Can the power to direct the most significant activities be conveyed through a non-variable interest decision-making fee?

Interpretive response: No. As discussed in Question 6.2.30, if an enterprise does not have a variable interest, it cannot be the VIE's primary beneficiary. This includes when the enterprise is a decision-maker. Examples 3.8.10, 3.8.20 and 3.8.30 illustrate this guidance.

There are situations in which a decision-maker concludes its fee arrangement is not a variable interest but some other involvement with the VIE is a variable interest. For example, the decision-maker may have an equity investment in the VIE that is not part of the fee arrangement (see Question 3.8.70).

However, this combination of arrangements cannot result in the decision-maker being the primary beneficiary of the VIE as described in Question 6.2.70 if the decision-maker's fee is not a variable interest. This is because the equity investment (i.e. the decision-maker's only variable interest) cannot meet the significant variable interest criterion. If the equity investment did meet the significant variable interest criterion, the decision-maker's fee arrangement would be a variable interest. A decision-maker's fee arrangement is a variable interest if the decision-maker's other variable interests absorb more than an insignificant amount of the VIE's variability (see section 3.8).

Typically, a single decision-maker whose fee is a variable interest will also meet the significant variable interest criterion and Step 2 will not be required (see Question 6.6.150).

Question 6.2.90

Can a VIE be the primary beneficiary of another VIE?

Interpretive response: Yes. An enterprise is the primary beneficiary of a VIE if it meets the two primary beneficiary criteria. Nothing precludes a primary beneficiary from being a VIE (see section 3.4.50).

Further, a VIE can consolidate a silo VIE (see section 3.7).

Question 6.2.100

Can more than one primary beneficiary be identified?

Interpretive response: No. Only one enterprise (if any) can be identified as the primary beneficiary of a VIE. Although more than one enterprise may meet the significant variable interest criterion, only one enterprise can meet the power criterion. [810-10-25-38A(b)]

Question 6.2.110
Is it possible for different enterprises to identify different primary beneficiaries?

Interpretive response: Yes. Enterprises will need to exercise judgment to determine which enterprise meets the power criterion. As a result, inconsistent primary beneficiary conclusions may arise.

However, in our experience, the risk of inconsistency is mitigated to an acceptable level if all enterprises use:

— complete and accurate information; and
— sound judgment when considering pertinent factors and characteristics of both variable interests and the VIE.

Question 6.2.120
If an enterprise concludes that it is not a legal entity's primary beneficiary, must it still evaluate whether that entity is a VIE?

Interpretive response: Yes. Even though an enterprise may not be a legal entity's primary beneficiary, there are disclosure requirements that apply to non-primary beneficiary variable interest holders of a VIE.

The following table summarizes the impact of a few possible scenarios.

If…	Then…
The enterprise holds a variable interest in the legal entity but is not the legal entity's primary beneficiary	Determine whether entity is a VIE, and if so, apply disclosure requirements (section 8.3.20)
The enterprise does not hold a variable interest in the legal entity	No further analysis is required (Question 6.2.30)
The legal entity is not a VIE	Apply the VOE consolidation model (chapter 5)

6.3 Power criterion

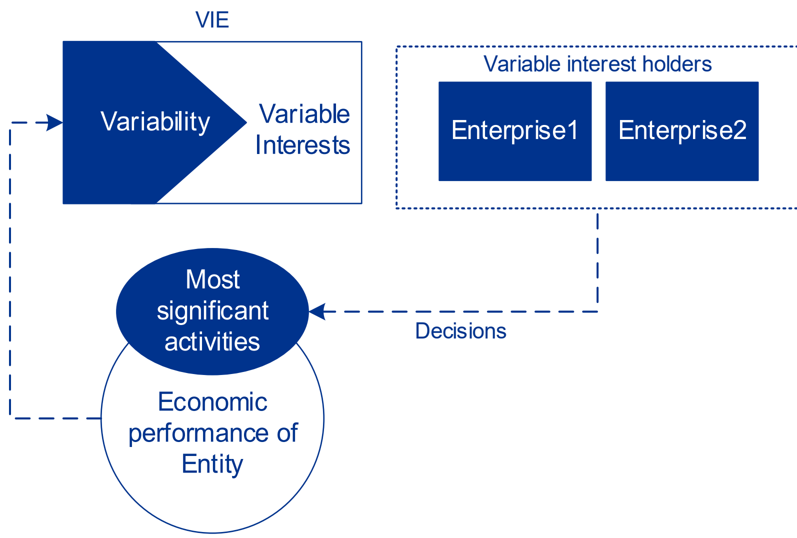
6.3.10 Overview

An enterprise must have the power to direct the activities that most significantly impact the VIE's economic performance to conclude that it is the VIE's primary beneficiary. This is the first of two criteria in the primary beneficiary analysis and applying it can be a very involved process. [810-10-25-38]

The broad steps in applying the power criterion are as follows.

Step 1	**Identify** the **activities that most significantly impact** a VIE's economic performance (see section 6.3.20).
Step 2	**Identify** the **party with the power** to control the activities identified in Step 1 (see section 6.3.30).

More than one variable interest holder might be involved in making decisions that affect the activities and the economic performance of the VIE through the creation and absorption of variability. However, only the party with the power to control the most significant activities meets the power criterion. This criterion is illustrated through the following diagram.



6.3.20 Step 1: Identify most significant activities

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

25-38A …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

…

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.…

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.

The activities that most significantly impact a VIE's economic performance may differ by type of entity. Therefore, judgment is required when identifying these activities. [810-10-25-38A(a), 25-38B]

Question 6.3.10

What is the process for identifying the most significant activities?

Interpretive response: We recommend first identifying the population of activities that impact a VIE's economic performance (see Question 6.3.20) and then determining which ones most significantly impact performance (see Questions 6.3.30 to 6.3.80).

Question 6.3.20

What factors does an enterprise consider when identifying activities impacting the economic performance of a VIE?

Interpretive response: Topic 810 includes a number of factors to consider when identifying the activities impacting the economic performance of a VIE (not exhaustive): [810-10-25-38B]

— the VIE's purpose and design – i.e. what risks is the entity designed to create and pass on to its variable interest holders (see section 3.3);
— the nature and characteristics of the VIE's activities and operations (see section 3.3);
— the risk(s) that the VIE was designed to create and pass along to its variable interest holders (see Question 3.3.30);
— the rights contained in contractual arrangements and/or the VIE's governing documents (see section 3.3); and
— the rights provided by management, servicing and/or other arrangements (see section 3.8).

It is important for an enterprise to establish a process to aggregate a VIE's activities and monitor whether changes to those activities, or which activities most significantly impact economic performance, have occurred. This is because the primary beneficiary assessment must be performed on a continuous basis (see Question 6.7.10). Changes to a VIE's activities might also trigger a reconsideration of whether the legal entity is a VIE and/or the identification of variable interests. Section 4.8 discusses reconsideration of VOE/VIE status.

Question 6.3.30

Must an enterprise identify a single activity that most significantly affects economic performance?

Interpretive response: Not necessarily. After identifying the population of activities that impact the VIE's economic performance, an enterprise must determine which of these activities most significantly impact the VIE's economic performance.

An enterprise may or may not determine that a single activity or a group of activities most significantly impacts economic performance. The view that a single activity need not be identified was expressed by the SEC staff (see below). [2010 AICPA Conf]

Excerpt from SEC staff speech

[R]egarding power, we have been asked about the nature of the activities and how a registrant should consider these activities when evaluating who has power over the entity. One piece of advice I have is: when considering the activities that most significantly impact economic performance, it may not be necessary to conclude on which single activity most significantly affects economic performance but rather it may be appropriate to consider a group of activities. This will obviously depend on the structure of the entity and the purpose and design of the entity.

Paul A. Beswick, Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments

Question 6.3.40

What is the process for identifying the activities that most significantly impact a VIE's economic performance?

Interpretive response: An enterprise may use a qualitative or quantitative analysis to identify the activities that most significantly impact a VIE's economic performance. The type of analysis used depends largely on the nature of the VIE's purpose and design – i.e. what risks is the entity designed to create and pass on to its variable interest holders (see section 3.3).

For example, a qualitative analysis may be appropriate if the VIE is designed to perform only a few key activities. In contrast, if it is designed to perform two or more subsets of activities, a quantitative analysis may prove more effective. An enterprise does not need to exercise its power to meet the power criterion (see Question 6.3.150). [810-10-25-38B]

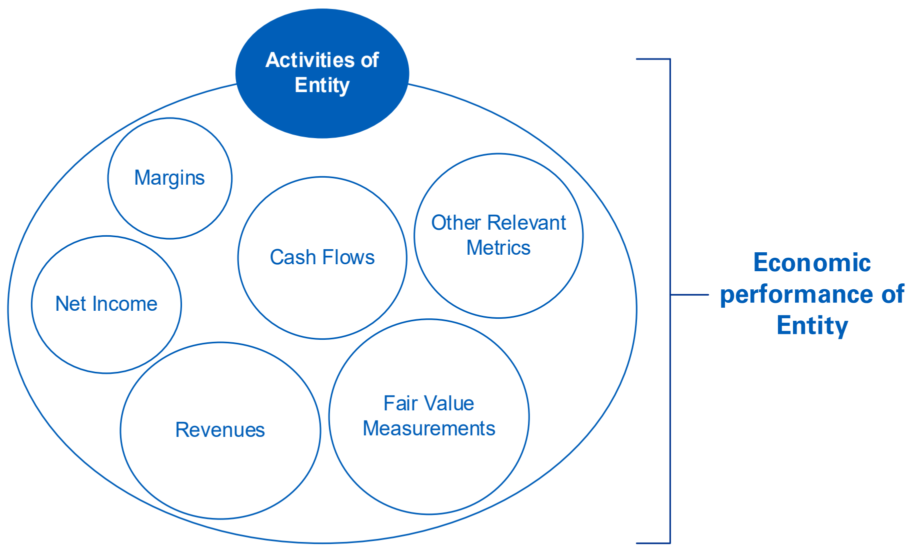
Qualitative analysis

A qualitative analysis may entail analyzing the decisions made by the variable interest holders, as well as decisions expected to be made over the VIE's expected life, and the impact of these decisions on the risks that the VIE was designed to create and pass along to its variable interest holders. [810-10-25-38B]

Quantitative analysis

If a VIE is more complex and has several subsets of activities, the enterprise may consider using a quantitative analysis to determine which activities are most significant.

For example, an enterprise may quantify how each of the identified activities affects relevant metrics that measure the VIE's economic performance.



Some financial metrics may be more significant depending on the nature of the VIE being evaluated. Determining which metrics to use when evaluating a particular activity's effect on economic performance requires judgment. Careful consideration should be given to:

- marketing materials;
- governing documents;
- margins; and
- contractual documents.

The above list is not exhaustive, and the enterprise may need to consider other arrangements as appropriate.

Question 6.3.50

Are the activities that most significantly impact an entity's economic performance the same when evaluating whether an entity is a VIE and determining the primary beneficiary?

Interpretive response: Yes. The activities that most significantly impact an entity's performance when evaluating the entity's VIE status should be the same as those that are evaluated when identifying that entity's primary beneficiary. [FAS 167.A63, 810-10-15-14, 25-38B]

Question 6.3.60

How has the SEC staff analyzed the activities that most significantly impact a VIE?

Interpretive response: The SEC staff has given its views about the identification of the activities that most significantly impact an entity's economic performance – emphasizing the importance of applying sound judgment and carefully considering the facts when performing this assessment. [2010 AICPA Conf]

Excerpt from SEC staff speech

Why is [identifying the scope and duration of the variable interest entity's activities that are significant to the entity's economic performance] so important? Well, it is important because identifying the activities of a variable interest entity is central to determining which party has power over those activities. And that's important because the party with power over those activities has the first of two necessary characteristics of a controlling financial interest.

In one situation, we objected to a view that had attributed activities to a variable interest entity that were not part of the entity, were performed by parties that had no involvement with the entity, and were not related parties or de facto agents of any party that was involved. We did not consider those activities to be the entity's own activities.

In another situation, we objected to a view that excluded activities that were significant and necessary to the entity accomplishing its purpose and design. An arrangement in this area included an entity designed to hold assets to maturity and fund those assets by rolling over short-term debt financing. The registrant had truncated its assessment of the activities to those associated with the initial debt, without considering activities associated with rolling over the debt or selling the assets and liquidating the arrangement.

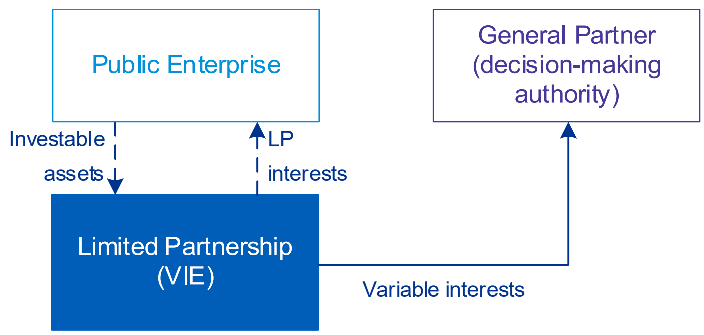
The effect of the views in both instances would have been that neither the reporting entity nor any other party had a controlling financial interest. While those situations may arise, one must first properly identify the entity's activities before reaching such a conclusion.

Wesley R. Bricker, Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments

Further, the SEC staff has given its views about the power to direct the most significant activities of an entity by explaining two consultations. [2019 AICPA Conf]

Consultation 1: Limited partnership investment guidelines

The first consultation involved a public enterprise that was significantly involved in establishing the investment guidelines of a VIE and had the right to modify certain aspects of the guidelines. However, an unrelated GP that held a variable interest in the VIE had the unilateral discretion to make investment decisions in accordance with the investment guidelines. The arrangement is illustrated in the following diagram.



The SEC staff made the following observations about this consultation.

Excerpt from SEC staff speech

Identifying the party with the power to direct the activities that most significantly impact a VIE's economic performance is an area of judgment that requires a careful evaluation of the entity's purpose and design and the variability that the entity is designed to create and pass along to its interest holders.[1]

The staff recently considered a consultation where a registrant contributed its investable assets into a newly-formed limited partnership in exchange for limited partnership interests. The limited partnership met the definition of a VIE and the VIE's primary purpose was to manage the investable assets pursuant to broad investment guidelines. The registrant was significantly involved in establishing the investment guidelines and had the contractual right to modify certain aspects of the guidelines. A general partner, who held a variable interest in the VIE, had the unilateral discretion to make investment decisions in accordance with the investment guidelines. The registrant concluded the activity that most significantly impacted the VIE's economic performance was making investment decisions and that the registrant did not have power over this activity.

The staff evaluated the investment guidelines to determine if the registrant had power over investment decisions through its ability to modify certain aspects of the investment guidelines or whether the general partner had power over the investment decisions through its day-to-day management rights. The staff observed that while the registrant could modify certain aspects of the guidelines, it did not have the ability to significantly limit the general partner's discretion over current and future investment decisions. Rather, the guidelines were designed to provide the general partner with significant discretion to make day-to-day investment decisions. Accordingly, the staff did not object to the registrant's conclusion that it did not control the VIE's most significant activity.

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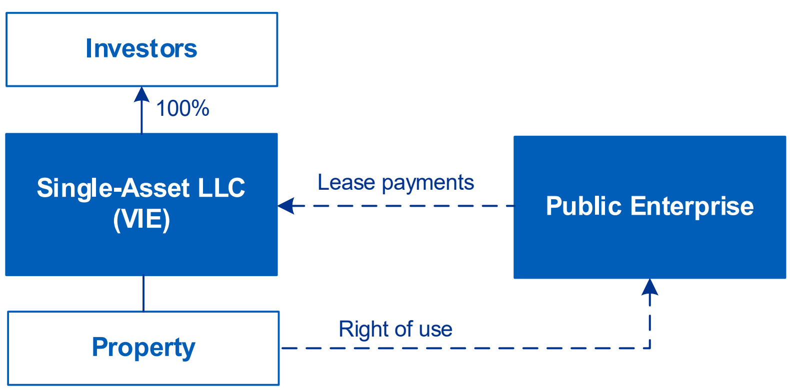
[1] ASC 810-10-25-22.

Aaron Shaw, Remarks before the 2019 AICPA Conference on Current SEC and PCAOB Developments

For guidance on decision-making authority, see section 3.8.10. For guidance on identifying a VIE's relevant activities when applying the by-design approach for identifying variable interests, see section 3.3.

Consultation 2: VIE lessor arrangement

The second consultation involved a public enterprise that leased the only asset of a VIE for substantially all of its economic life. Although the investors in the VIE had lease negotiation risk and lessee credit risk, the public enterprise retained residual value risk and operation and maintenance risk. The arrangement is illustrated in the following diagram.



The SEC staff made the following observations about this consultation.

Excerpt from SEC staff speech

Continuing with the second consultation on identifying the primary beneficiary, a VIE may have multiple risks and multiple activities that impact the entity's economic performance. However, the importance of each risk and each activity to the consolidation analysis is not necessarily identical.[2] The staff recently considered a consultation regarding a VIE that was designed to serve as a single-asset LLC whose primary purpose was to lease its single property to a registrant for substantially all of the property's economic life and to provide a return to its investors through the lease payments and sale of the property at the end of the lease. The lease obligated the registrant to operate and maintain the property, including any significant structural maintenance. Additionally, the VIE had the right to sell the property at the end of the lease. The registrant, or lessee, concluded that it had multiple variable interests in the VIE but did not have power over the activities that most significantly impacted the VIE's economic performance and therefore did not consolidate the VIE.

Based on the VIE's purpose and design, the risks that caused variability included: lease negotiation risk, lessee credit risk, residual value risk, and operation and maintenance risk. Activities related to lease negotiation risk were not the VIE's most significant activities, primarily because the lease term covered substantially all of the property's economic life. Activities related to lessee credit risk were not the VIE's most significant activities because the registrant's financial condition and the property's strategic importance mitigated credit risk. Rather, the staff determined that activities related to residual value risk and operation and maintenance risk were the VIE's most significant activities. The staff observed that operation and maintenance decisions made by the registrant during the lease term would most significantly impact the VIE's economic performance. Therefore, the staff objected to the registrant's conclusion that it did not have power over the VIE's most significant activities.

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[2] ASC 810-10-25-38A(a) focuses on the power to direct the activities of a VIE that most significantly impact the VIE's economic performance.

Aaron Shaw, Remarks before the 2019 AICPA Conference on Current SEC and PCAOB Developments

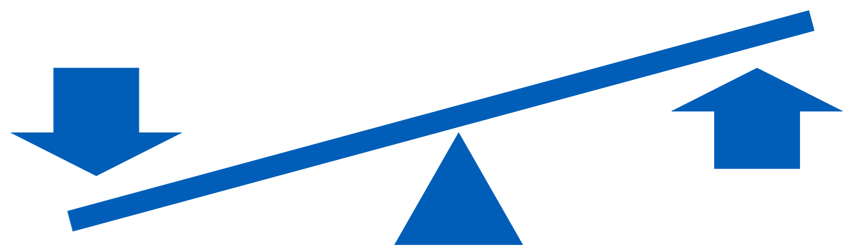
For guidance on leasing arrangements, see section 3.4.40. For guidance on identifying a VIE's relevant activities when applying the by-design approach for identifying variable interests, see section 3.3.

Question 6.3.70

Is it possible for a VIE not to have any activities that significantly impact its economic performance?

Interpretive response: No. Power is determined on the basis of who directs a VIE's activities. This is the case even if the VIE has a limited range of activities. As discussed in section 6.3.30, an enterprise's significant involvement in the design of a VIE may indicate that the enterprise has power. This is because involvement in the design may provide the opportunity and the incentive to establish arrangements that result in the enterprise being the variable interest holder with power. Therefore, analyzing the power criterion requires consideration of the involvement an enterprise had with the design of the VIE.

Further, as discussed in section 6.6.30, it is important to consider an enterprise's stated power over a VIE compared to the enterprise's economic interest in the VIE. When a disproportionate balance exists, an enterprise's economic interest may be indicative of the amount of power it holds.



In general, an enterprise with the following is expected to meet the power criterion:

- an economic interest that absorbs substantially all of the VIE's economic risks and rewards; and
- involvement in the VIE's design – e.g. the selection of the assets to be held by the entity, the classes of variable interests to be issued by the entity.

Multiple parties may be involved in a VIE's design. In such cases, the economic interests of each party are analyzed to determine which party (if any) meets the power criterion. A party with an economic interest that absorbs substantially all of the VIE's economic risks and rewards generally meets this criterion in these circumstances. For guidance on shared power, see section 6.5.10.

VIEs with activities that are highly restricted/limited

All VIEs have some form of decision-making. This is true for a VIE even if its activities or operations are restricted – e.g. operated under pre-defined governing documents, such as a securitization trust.

The following considerations (not exhaustive) may be relevant when identifying the activities that most significantly impact the economic performance of an entity with highly restricted activities.

- The ability to direct the activities of the VIE only upon the occurrence of certain events or circumstances may constitute power if the related activities are those that most significantly impact the VIE's economic performance.
- The enterprise's involvement in the VIE's design and structuring may provide insight into the VIE's most significant activities. For entities with a limited range of activities, it is likely that the activities associated with designing the VIE most significantly impact the VIE's economic performance. This includes VIEs with ongoing activities limited to administrative and similar functions that do not significantly affect their economic performance.

The SEC staff has given its views about analyzing VIEs with highly restricted activities by discussing certain financial entities (see below). [2010 AICPA Conf]

Excerpt from SEC staff speech

Financial entities that are designed to have only a limited range of activities – such as those used in certain securitization and other single-purpose activities – may require particularly careful consideration. The evaluation of power often requires an analysis of the decisions made at inception of the entity, including those reflected in the entity's formation documents. But it doesn't stop there. The evaluation of power also requires an analysis of any ongoing activities and which party or parties have power over those activities.

Wesley R. Bricker, Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments

Example 6.3.10

Power analysis for entities with highly restricted activities

Background

RE REMIC is a resecuritization of real estate mortgage investment conduit securities.

The ongoing activities of RE REMIC are limited to only administrative and similar functions. These ongoing activities do not significantly affect RE REMIC's economic performance.

Evaluation

While the ongoing activities are administrative in nature, there are nevertheless activities that significantly impact RE REMIC's economic performance. Otherwise, there would have been no business reason to create RE REMIC.

There are multiple parties involved in the formation of RE REMIC:

— an investment bank;
— bank or other investor that holds the subordinated tranche of the structure;
— an investor in the senior tranche of the structure;
— other parties.

In general, a party that was involved in the design and structuring of the arrangement meets the power criterion if that party holds an interest that absorbs substantially all of RE REMIC's economic risks and rewards. The design and structuring of an arrangement includes the selection of the assets to be held by RE REMIC and the classes of variable interests to be issued to achieve the desired rating of the senior interests. Typically, the economic risks and rewards are concentrated in the subordinated tranche(s) of the structure.

Question 6.3.80

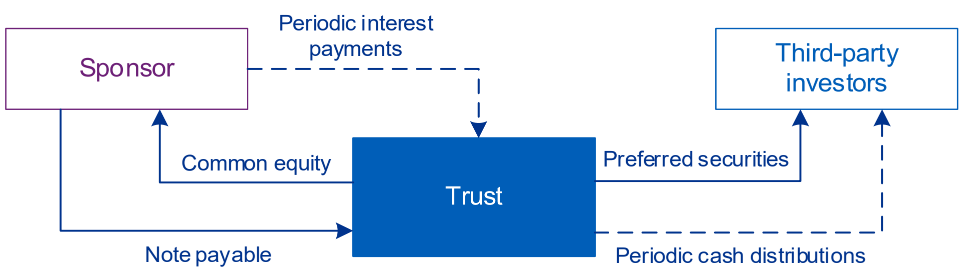
In a trust preferred structure, which party has the power to direct the most significant activities?

Background: In a typical trust preferred structure, a sponsor, usually a bank, establishes a limited purpose trust (Trust) by contributing cash in exchange for all of the Trust's common equity. The purpose of the Trust is to issue trust preferred securities to third-party investors and use the proceeds of the issuance to extend an equal amount of financing to the sponsor. The financing to the sponsor is typically in the form of junior subordinated debentures, notes or other instruments that have stated maturity dates (the 'notes').

The notes are the only assets of the Trust. When the sponsor makes its interest payments on the notes, the Trust distributes the cash to the holders of the trust-preferred securities. The trust-preferred securities must be redeemed on maturity of the notes.

In some structures, the Trust writes a fixed-price call option to the sponsor that is embedded in the obligation of the sponsor to the Trust. This call option permits the sponsor to call the notes, for example at par. The option is generally exercisable beginning sometime after the issuance of the trust-preferred securities. The sponsor typically holds all of the common equity of the Trust.

The following diagram illustrates a typical trust preferred arrangement.



Interpretive response: Generally, the sponsor. In a trust preferred structure, the sponsoring enterprise typically has the power to direct the activities that most significantly impact the trust's economic performance. This is because the sponsor is significantly involved in the design of the trust. Therefore, because the range of activities of a trust are limited, the design of the trust greatly impacts its economic performance (see Question 6.3.70).

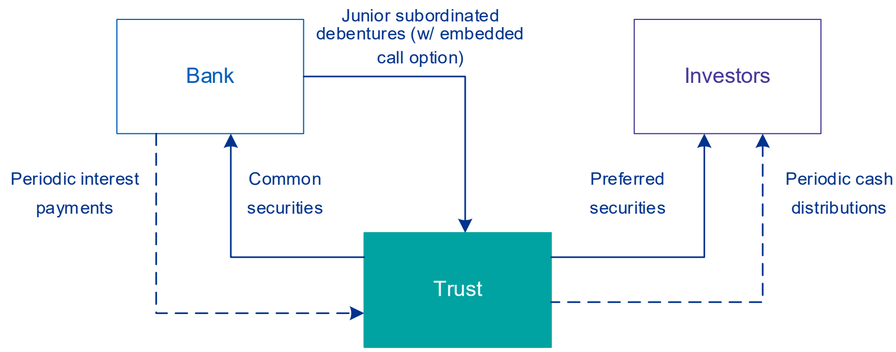
However, if the sponsoring enterprise meets the power criterion, but does not have a variable interest in the Trust, it cannot be the Trust's primary beneficiary (see Question 6.2.30).

See Question 3.4.20 for guidance on evaluating whether the common equity represents a variable interest in the trust.

Example 6.3.20
Evaluating power in trust-preferred securities arrangements

Background

Bank decides to issue trust preferred securities. To facilitate the issuance of these securities, Bank forms a limited-purpose trust (Trust).



— Bank purchases all of Trust's common securities, which represents 3% of the overall capital of Trust.

— Trust issues preferred securities to investors and uses the proceeds to purchase an equivalent amount of junior subordinated debentures or other loans (with terms identical to those of the trust preferred securities) from Bank.

— The debentures or other loans are the only assets of Trust.

— When Bank pays interest on the debentures or other loans, Trust distributes the cash to the holders of the trust-preferred securities.

— The trust-preferred securities must be redeemed on maturity of the Bank loan.

— Trust writes a fixed-price call option to Bank that is embedded in the obligation of Bank to Trust. The call option allows Bank to call the loans at par at any time beginning five years after issuance of the trust preferred securities.

Evaluation

Bank is the party with the power to direct the activities that most significantly impact Trust's economic performance. Therefore, Bank meets the power criterion. In making this determination, the following considerations are relevant in this example.

— The purpose of Trust is to provide investors with the ability to invest in junior subordinated debentures of Bank and provide Bank with necessary financing.

— The principal risks to which Trust is exposed are credit risk of its underlying assets (essentially credit risk of Bank) and prepayment risk.

- The economic performance of Trust is most significantly impacted by the performance of its underlying assets.
- The activities of Trust are restrictive and are predetermined.
- Bank was significantly involved in the design of Trust.
- Bank is the only entity that can significantly impact the performance of the underlying assets of Trust (through exercise of the call option). This is the case regardless of whether Bank intends to exercise the option (see Question 6.3.150).

For Bank to be Trust's primary beneficiary, Bank must also meet the significant variable interest criterion (see section 6.2). However, Bank does not meet this criterion because it does not hold a variable interest. This is true because:

- Bank's common stock investment in Trust is not a variable interest because it absorbs a risk created by its holder. An enterprise cannot absorb variability that it creates (see Question 3.4.20).
- following the 'clearly and closely related' guidance (see section 3.4.20), Bank is required to ignore the embedded call option when identifying variable interests.

Because no enterprise meets both of the primary beneficiary criteria, Trust is not consolidated.

Question 6.3.90

Are the activities that convey power limited to those that create the variability absorbed by the equity-at-risk group?

Interpretive response: No. The activities that most significantly impact a VIE's economic performance are not limited to those that affect the variability absorbed by the equity-at-risk group. Therefore, an enterprise considers all activities that significantly impact a VIE's economic performance when determining which enterprise has power over the VIE. This is regardless of which variable interest holders absorb the variability arising from those activities.

When identifying these activities, the enterprise evaluates the VIE's purpose and design as well as the risks and variability that the VIE was designed to create and pass along to the variable interest holders (see section 3.3 and Question 6.3.120). [810-10-25-38A]

Question 6.3.100

When a VIE's significant activities occur outside of the VIE, are they relevant to evaluating the power criterion?

Interpretive response: Yes. An enterprise may meet the power criterion regardless of whether the corresponding activities occur within or outside of the VIE. An enterprise cannot avoid consolidating a VIE simply as a result of activities occurring outside of the VIE.

Such outside activities are activities that:

— are integral to the VIE's other activities; and
— would significantly affect the VIE's economic performance if they were engaged in by the VIE.

Therefore, the enterprise needs to consider those activities when evaluating the power criterion. Although activities may occur outside of a VIE, an enterprise may nevertheless have the power to direct the activities that most significantly impact the VIE (see Example 6.3.30).

6.3.30 Step 2: Identifying the party with power

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

25-38A A reporting entity with a variable interest in a VIE shall assess whether the reporting entity has a controlling financial interest in the VIE and, thus, is the VIE's primary beneficiary. This shall include an assessment of the characteristics of the reporting entity's variable interest(s) and other involvements (including involvement of related parties and de facto agents), if any, in the VIE, as well as the involvement of other variable interest holders…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…

…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….

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...

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.

Once an enterprise has identified the activities that most significantly impact the VIE's economic performance (see section 6.3.20), it needs to determine which party has power over these activities. The manner in which power is conveyed to an enterprise depends on the nature of the activities identified. [810-10-25-38A]

When identifying the party with power, kick-out rights and participating rights are only considered if a single enterprise has the unilateral ability to exercise those rights and the rights are substantive (see section 6.4). [810-10-25-38C]

Question 6.3.110

What is the process for determining which party has power over the activities that most significantly impact a VIE's economic performance?

Interpretive response: An enterprise must first evaluate whether it individually meets the power criterion. For example, it might individually meet this criterion if it was significantly involved in the VIE's design.

If an enterprise concludes that it does not meet this criterion by itself, it must then evaluate whether it does when considering its involvement with other parties, including related parties. [810-10-25-38F]

Step 1	Does the enterprise, individually, meet the power criterion?
Step 2	Does the enterprise, when considering other parties, meet the power criterion?

The enterprise could meet the power criterion under Step 2 by virtue of its relationship with related parties that also have interests in the VIE or by sharing power with other parties. See section 6.5 for additional guidance on how shared power and related party interests affect the primary beneficiary analysis. The remainder of this section focuses on applying Step 1.

Question 6.3.120

Does the party that meets the power criterion typically direct the activities that create the VIE's variability?

Interpretive response: Yes. When determining which entity has power, an enterprise evaluates the purpose and design of the VIE and the risks the entity is designed to create and pass on to its variable interest holders (see section 3.3). The enterprise should understand how these risks affect the VIE's economic performance and the activities that relate to each risk. See Question 3.3.30 for example risks to consider.

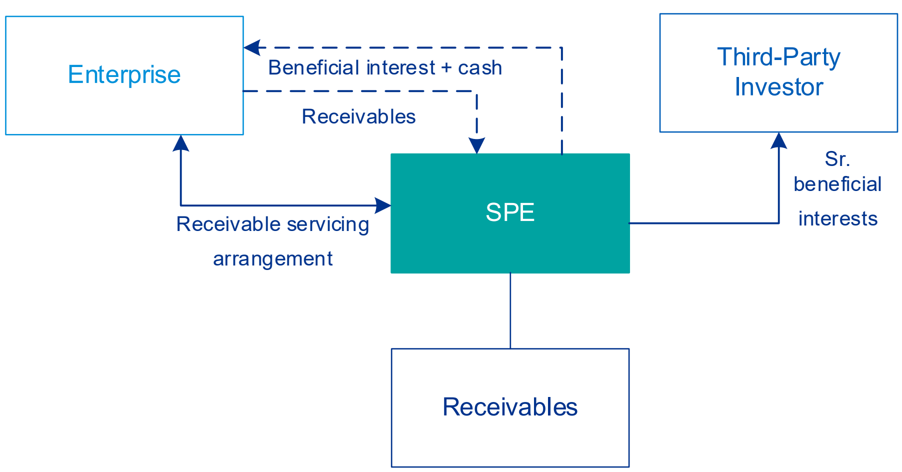
Example 6.3.30

Sources of power

Background

Enterprise transfers receivables to SPE, which issues cash and beneficial interests to Enterprise as proceeds. Third parties hold the remaining beneficial interests in SPE, which are senior to those held by Enterprise.

Enterprise is responsible for servicing the receivables transferred to SPE. As part of its servicing responsibilities, on the default of a receivable, Enterprise will repurchase the receivable from SPE at par or direct the trustee to sell the receivable. After a repurchase, Enterprise will continue to service the receivable, including collection activities.



In this transaction, SPE has no ongoing activities. Enterprise retains substantially all credit risk if any of the receivables it transferred to SPE default. Enterprise must either direct the trustee to sell the assets or may choose to purchase the assets from SPE and initiate its own collection process.

Evaluation

The management of defaulted receivables is considered the activity that most significantly impacts the economic performance of SPE. However, the loss mitigation or collection procedures do not occur within SPE itself; instead, Enterprise must repurchase the assets from SPE or direct the trustee to sell the receivables. Although these activities occur outside of SPE (see Question 6.3.100), Enterprise nevertheless has the power to direct the activities that most significantly impact SPE's economic performance.

Note: The activities in this example are integral to the VIE's other activities and are performed by an enterprise involved with the VIE. As a result, this fact pattern can be distinguished from the warning by the SEC staff not to attribute activities to a VIE that are not part of the entity (see Question 6.3.60).

Question 6.3.130

Can an enterprise identify a party with power if it cannot link the VIE's risks with specific activities?

Interpretive response: Yes. There may be situations where certain risks cannot be linked to specific activities that are directed by the variable interest holders. However, this does not prevent an enterprise from determining that it meets the power criterion. Examples of such situations are illustrated in section 6.8 (Cases E and F in paragraphs 810-10-55-147 to 55-171).

Case E

A guaranteed mortgage-backed securitization transaction is structured as follows.

- VIE purchases 30-year fixed-rate residential mortgages. 100% of the credit losses of VIE's assets are guaranteed by a third party (Guarantor). VIE issues one class of investment-grade 30-year fixed-rate debt securities to its investors to fund their purchase.
- Guarantor is the servicer of the securities issued by VIE ('master servicer'), is paid a monthly fee and can only be removed for a material breech in its obligations. The fee represents a variable interest in VIE.
- Guarantor hires the transferor to service the assets held by VIE ('primary servicer') and can remove the servicer if it considers removal to be in the best interest of the security holders. The primary servicer is paid a monthly fee. The fee does not represent a variable interest in VIE.
- The economic performance of VIE is most significantly impacted by the performance of its underlying assets.
- Guarantor has the ability to manage VIE's assets that become delinquent (or may become delinquent in the reasonably foreseeable future) to improve the economic performance of VIE.

The risks that VIE was designed to create and pass along are as follows.

Principal risks to which VIE is exposed	Director of activities related to risks
Credit risk of the underlying assets	Guarantor. Further, this risk is fully absorbed by Guarantor.
Prepayment risk	None of the variable interest holders has the power to direct activities related to this risk.
Risk of fluctuations in the value of the underlying real estate	Guarantor. Further, this risk is fully absorbed by Guarantor.

Even though one of the risks to which VIE is exposed cannot be linked to a specific activity, this does not prevent Guarantor from concluding that it meets the power criterion. See also the guidance on an enterprise's involvement in the design of a VIE in Question 6.3.140.

Case F

A residential mortgage-backed securitization is structured in the same manner as Case E, with the following differences.

— VIE issues 2 tranches of securities (90% senior and 10% residual). The residual tranche is held by the transferor and absorbs any losses prior to the senior tranche.

— The primary servicing responsibilities are retained by the transferor; no party has the ability to remove the servicer. The fees paid to the primary servicer are a variable interest.

— The acceptable default mitigation strategies are limited to actions specified in the servicing agreement.

The risks that VIE was designed to create and pass along are as follows.

Principal risks to which VIE is exposed	Director of activities related to risks
Credit risk of the underlying assets	The transferor, as servicer, has the ability to manage VIE's assets that become delinquent (or are reasonably foreseeable of becoming delinquent) to improve the economic performance of VIE.
Prepayment risk	None of the variable interest holders has the power to direct activities related to this risk.
Risk of fluctuations in the value of the underlying real estate	The transferor, as servicer, has the ability to manage VIE's assets that become delinquent (or are reasonably foreseeable of becoming delinquent) to improve the economic performance of VIE.

Even though one of the risks to which VIE is exposed cannot be linked to a specific activity, this does not prevent the transferor from concluding that it meets the power criterion. See also the guidance on contingent power in Questions 6.3.140 and 6.3.160.

Question 6.3.140

Does an enterprise automatically meet the power criterion if is significantly involved in a VIE's activities and operations?

Interpretive response: No. Significant involvement in an entity's activities and operations does not, in isolation, establish the enterprise as the party meeting the power criterion. However, such involvement may indicate that the enterprise had the opportunity and the incentive to establish arrangements that result in the enterprise having power. [810-10-25-38F]

We believe the enterprise should consider:

— the characteristics of the entity's activities and operations;
— involvement of the variable interest holders in the VIE's design;
— the terms of contractual arrangements entered into by the VIE; and
— the provisions of the VIE's governing documents.

For example, a sponsor may have an implicit agreement with the VIE to fund losses to protect the sponsor's reputation. As the result, the sponsor may have designed an entity in a manner that provides the sponsor with power. Therefore, it is important to consider the by-design approach, including an enterprise's involvement with the design of an entity when evaluating the power criterion. See Question 3.5.120 for guidance on this type of implicit arrangement, and section 3.3 for guidance on the by-design approach.

Question 6.3.150

If an enterprise doesn't plan to exercise its power, can it still meet the power criterion?

Interpretive response: Yes. Whether or not an enterprise intends to exercise its power is not relevant in the power analysis. An enterprise does not need to exercise its power to meet the power criterion. [810-10-25-38B]

Question 6.3.160

How is the power criterion affected if an enterprise obtains power upon the occurrence of a specified event or circumstance?

Interpretive response: Generally, an enterprise considers how the VIE's existing assets and operations are expected to impact its economic performance over its entire life cycle when identifying:

— the VIE's most significant activities; and
— which party (if any) has the power to direct those activities.

As a result, if more than one enterprise has decision-making authority depending on the occurrence (or nonoccurrence) of a specified event ('contingent power'), an analysis is needed to determine which activities – i.e. those activities before or after the specific event – *most* significantly impact the VIE's economic performance.

Evaluating contingent power – all activities occurring over the VIE's life cycle

The analysis to determine which activities – i.e. those activities before or after the specific event – *most* significantly impact the VIE's economic performance depends in part on the:

- likelihood that the specified contingent event will occur; and
- the impact on the VIE's economic performance of the activities that occur before and after the specified event.

Activities that occur before the specified event may not have a significant impact on the VIE's economic performance if they:

- are routine or administrative in nature; or
- give rise to little variability in the VIE's economic performance and that variability can be managed through the actions taken by the party directing those activities.

This may be more common for entities that have highly restricted activities. If this is the case, the activities that occur after the specified event may have a more significant impact on the VIE's economic performance than those that occur before. In this case, the activities that occur after the specified event should be identified as those that most significantly impact the VIE's economic performance. An enterprise need not exercise its power to meet the power criterion (see Question 6.3.150).

Activities that occur after a specified event that do not have a significant impact on a VIE's economic performance are often subject to protective rights (see Question 6.3.200). In this case, the activities that occur before the specified event should be identified as those that most significantly impact the VIE's economic performance.

In any case, an enterprise must continuously evaluate which party (if any) is the primary beneficiary of the VIE (see section 6.7). As a result, an enterprise may conclude that:

- it initially consolidates a VIE because it believes the activities occurring before the specified event are the most significant (and it directs those activities); but
- it must deconsolidate the VIE if and when the specified event actually occurs because, at that point, another party directs the activities that are most significant for the VIE's remaining life cycle.

Evaluating contingent power – only specific activities carried out in each phase

However, we believe there is an exception to looking at the VIE's entire life cycle when:

- a VIE's activities are carried out in various phases that cannot occur concurrently; and

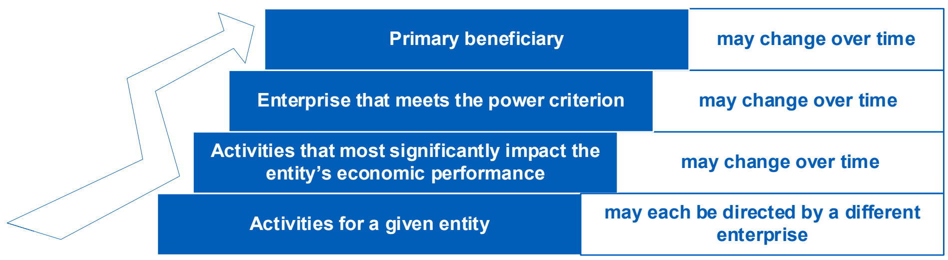
— it is unclear whether the current phase of the VIE's activities will be successfully completed.

A VIE's activities may be carried out in various phases that cannot occur concurrently. It may be unclear whether the current phase of the VIE's activities will be successfully completed, thereby casting doubt on whether the VIE can move to the next phase of its planned activities.

In these situations, it may be appropriate to initially apply the primary beneficiary criteria based on the particular phase the VIE is currently engaged in instead of the VIE's life cycle as discussed above.

The enterprise with power over those activities that currently have the most significant impact on the VIE's economic performance meets the power criterion. If and when the VIE moves onto the next phase (or it is probable that the VIE will move onto the next phase), the party that meets the power criterion is reassessed based the activities in the new phase.

The following diagram illustrates how aspects of the primary beneficiary analysis might change over time when a VIE's activities are carried out in phases.

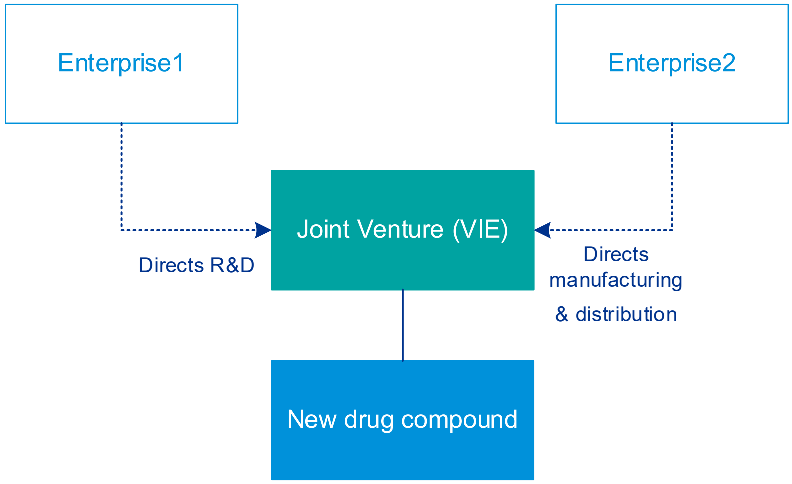


See section 6.7 for guidance on primary beneficiary reconsideration. See Question 4.3.270 for guidance on computing variability and evaluating the sufficiency of equity at risk for legal entities in the start-up phase.

Example 6.3.40
Contingent power analysis: Pharmaceutical venture

Background

Enterprise1 and Enterprise2 create Joint Venture to develop and distribute a new drug. VIE is structured whereby Enterprise1 has the power to make all required decisions related to R&D activities. Enterprise2 has the power to make all required decisions related to manufacturing and distribution activities.



Evaluation

Because the drug will require FDA approval, the two phases of the venture (i.e. R&D and manufacturing/distribution) will occur consecutively. Therefore, the party with power will change based on the phase of the venture.

Stage	Party meeting power criterion	Power may change
R&D	Enterprise1	When FDA approval becomes probable
Manufacturing and distribution	Enterprise2	

If it becomes clear that FDA approval will ultimately be received, and the manufacturing and distribution activities are expected to have a greater impact on Joint Venture's activities than the remaining R&D activities, then Enterprise2 has the power to direct the activities that most significantly impact Joint Venture's economic performance even though FDA approval has not yet been obtained.

Question 6.3.170

How is the power criterion affected if an enterprise directs only default mitigation activities if default occurs?

Interpretive response: We believe an enterprise considers contingent power triggered by default by evaluating which activities – i.e. those activities before or after the default event – most significantly impact the VIE's economic performance. This type of contingent power is most common in VIEs that hold predominantly financial assets.

We believe considering the activities occurring over the VIE's life cycle (versus by phase) is appropriate in this situation because default mitigation activities are not considered a separate phase in the activities of the VIE. This is because these entities are not designed to operate in stages or phases – i.e. defaults could occur at any time throughout the life of these VIEs.

Question 6.3.160 provides additional guidance on evaluating contingent power, including when it is appropriate to consider all activities occurring over the VIE's life cycle and when it is appropriate to consider only specific activities carried out during each phase.

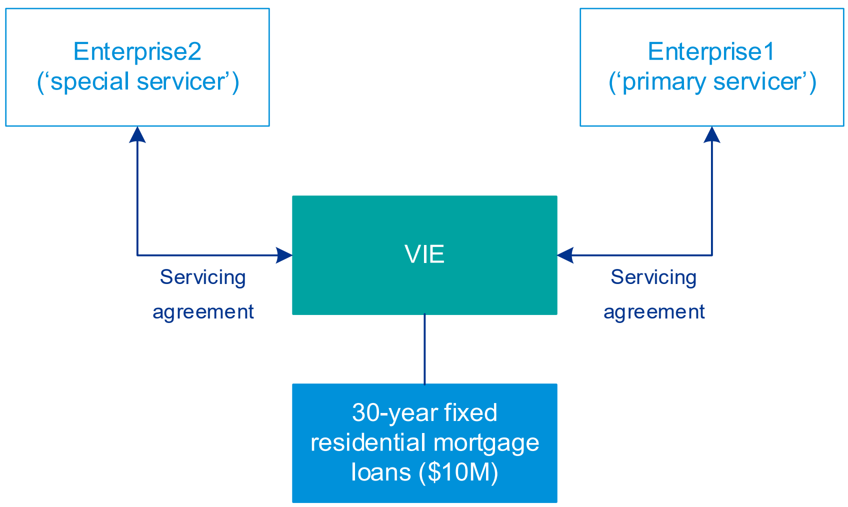
See Example 6.3.50 for an illustration of this guidance.

Example 6.3.50

Contingent power analysis: Default mitigation activities

Background

VIE's assets comprise $10 million of 30-year fixed-rate residential mortgage loans.



All of the activities of the VIE are pre-specified by the formation documents and no critical decisions are required unless the underlying mortgage loans default. Enterprise1 (primary servicer) and Enterprise2 (special servicer) perform the following activities.

Servicer	Activities directed
Enterprise1	Administrative activities associated with servicing the mortgage loans, such as collecting and remitting cash
Enterprise2	On the delinquency or default of the mortgage loans, takes control of the servicing activities

Evaluation

In its capacity as the special servicer, Enterprise2 is able to make more extensive decisions related to the management of the mortgage loans to recoup the maximum amount under the defaulted loans for the VIE's investors. Therefore, the activities that most significantly impact the economic performance of the VIE are those that may be made by Enterprise2. The activities directed by Enterprise1 are not most significant to the VIE's economic performance.

Note: An enterprise does not have to exercise its power to meet the power criterion. Therefore, even though the special servicing activities directed by Enterprise2 only arise on the occurrence of a specified contingent event, those activities provide Enterprise2 with the power to direct the activities that most significantly impact the economic performance of the VIE.

Question 6.3.180

Does a contingent protective right impact the power criterion?

Interpretive response: No. Protective rights that are contingent on the occurrence of specified events or circumstances do not convey power or prevent another enterprise from having power before the specified event occurs. An enterprise should distinguish between rights that convey power and rights that are protective in nature.

If and when the specified event does occur, the party that meets the power criterion is reassessed based on the VIE's remaining activities.

See Question 6.3.160 for guidance when power is contingent on the occurrence of specified events, and Question 6.3.190 for guidance on distinguishing protective rights from contingent power.

Question 6.3.190

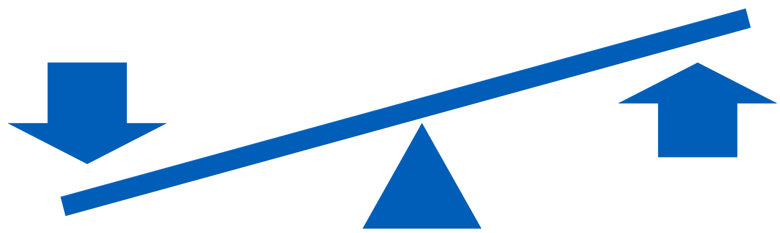
How is a protective right distinguished from contingent power?

Interpretive response: Protective rights pertain to activities that do not most significantly impact a VIE's economic performance. Power, contingent or otherwise, must convey the ability to direct the activities most significant to an entity's economic performance.

The following are some examples of protective rights: [810-10-25-10]

- amendments to articles of incorporation or partnership agreements of the investee;
- pricing on transactions between the owner of a majority voting interest or LP with a majority of kick-out rights through voting interests and the investee and related self-dealing transactions;
- liquidation of the investee or a decision to cause the investee to enter bankruptcy or other receivership;
- acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business;
- issuance or repurchase of equity interests.

Sometimes it may be unclear whether a right is a protective right or contingent power. In distinguishing between the two, an enterprise considers the design of the entity. The relationship between an entity's design and whether a right represents contingent power or a protective right can be illustrated as follows.



If…	Then…
...the VIE is an operating entity with a wide range of activities...	...power exercisable only on the occurrence of a specified event is more likely to represent a protective right
...the VIE is an operating entity with a limited range of activities...	...power exercisable only on the occurrence of a specified event is more likely to represent contingent power

When the VIE's range of activities is limited, there is a greater likelihood that the activities that occur before the specified event are routine in nature (discussed in Question 6.3.160). In these circumstances, the activities that occur after the specified event are likely to have a more significant impact on the VIE's economic performance than those that occur before the specified event. Therefore, power that is exercisable only on the occurrence of the specified event is more likely to meet the power criterion.

Question 6.3.200

Is the right to direct activities that occur after a specified event a protective right if the contingent activities are likely to have a less significant impact on the VIE's economic performance?

Interpretive response: Yes. If contingent activities are likely to have a less significant impact on the VIE's economic performance, the right to direct activities that occur after a specified event likely represents a protective right.

For example, a right that allows its holder to take possession of all assets of an operating business on a material adverse change in the operations of the business represents a protective right if:

— there is a low likelihood that the specified contingent event will occur; and
— the VIE's economic performance is most significantly impacted by the activities that occur before the specified event.

This scenario is further described in section 6.8 (Case I at paragraphs 810-10-55-199 to 55-205). The activities that occur after the specified event are likely to have a less significant impact on the VIE's economic performance than those that occur before the specified event. In that case, the right to liquidate the assets of a business on a default or a material adverse change in the operations of the business would not likely be the activity that most significantly impacts the economic performance of the business. Instead, this right is similar to a creditor's collateral right and represents a protective right.

While a protective right does not cause its holder to be the primary beneficiary, a right initially considered a protective right could cause its holder to meet the power criterion at a later date (see Questions 6.3.160 and 6.3.190).

Question 6.3.210

Does a lessee in a single-lessee leasing arrangement meet the power criterion with regard to the lessor?

Interpretive response: Sometimes. Section 6.8 (Case G at paragraphs 810-10-55-172 to 55-181) addresses a single-lessee leasing arrangement in the context of a synthetic lease. Although the lessee accounts for the lease as an operating lease, it is the owner of the property for tax purposes and therefore receives tax depreciation benefits. The lessor accounts for the lease as a direct financing lease.

The operating lease is not a plain vanilla operating lease. The lessee provides a residual value guarantee and has a fixed-price purchase option. If it chooses not to exercise its option, it is required to remarket the property on the VIE's behalf and is exposed to the losses or gains if the asset is sold for an amount less than or greater than the option strike price.

The Case concludes that the lessee meets the power criterion. In explaining this conclusion, the FASB includes the following points.

— The economic performance of the VIE is significantly impacted by the fair value of the underlying property and the credit of the lessee.

— The lessee's maintenance and operation of the leased property has a direct effect on the fair value of the underlying property.

— The lessee directs the remarketing of the property.

— The lessee has the ability to increase the benefits it can receive and limit the losses it can suffer by the manner in which it uses the property and how it remarkets the property.

The analysis of Case G implies that the economic utility of the leased asset enjoyed by the lessee during the lease term affects the evaluation of the power criterion. That economic utility becomes part of the lessor entity's economic performance, and the lessee is viewed as the party with the power to direct the activities pertaining to that portion of the lessor entity's economic performance. The effect of the leased asset's utility during the lease term on the lessor entity's economic performance must be weighed against the other factors that impact the lessor entity's economic performance. Other factors could include the leased asset's economic utility and changes in the asset's fair value after the end of the lease term.

When evaluating other single-lessee leasing arrangements similar to the one in Case G, it is important to evaluate the extent to which the lessee directs the lessor's economic performance. The lessee would need to be able to exercise power with respect to the decisions that most significantly impact the lessor entity's economic performance to meet the power criterion and be the primary beneficiary of the entity.

While the lessee would clearly have that power in a synthetic lease, it would not necessarily in all single-lessee leasing arrangements. For example, a single lessee of real estate may not have power with respect to a majority of the lessor entity's economic performance when the lease term is significantly shorter than the asset's remaining economic life. This is because real estate, unlike many other assets, often maintains its value or increases in value over time. As a result, the party that controls the long-term decisions about the asset typically is the entity's primary beneficiary.

In single-lessee leasing arrangements of non-real estate assets, a lessee that takes on a majority of the risk of the leased asset over its remaining economic life may meet the power criterion. The lessee may be the primary beneficiary of the lessor entity until the lessee ceases to be exposed to a majority of the risk of the leased asset over its remaining economic life. This can occur before the lease arrangement terminates or is modified.

In any case, a lessee can only be the primary beneficiary of the lessor if it has a variable interest in the lessor (see section 3.4.40) and it meets the significant variable interest criterion (see section 6.6).

Question 6.3.220

Does a purchaser in a power purchase arrangement meet the power criterion with regard to the seller?

Interpretive response: Sometimes. We believe that offtake arrangements, such as power purchase and capacity purchase arrangements, should be evaluated similarly to single-lessee leasing arrangements (see Question 6.3.210).

The purchaser (offtaker) should determine whether it has a variable interest in the seller (provider of power/capacity), which may be affected by whether the arrangement contains a lease. If the purchaser has a variable interest in the seller, that will likely cause the seller to be a VIE because the seller's equity investors will likely lack one or more of the equity-at-risk characteristics (see section 4.3). If the purchaser has a variable interest in the seller and the seller is a VIE, the purchaser must evaluate whether it meets the power criterion, which will depend in part on the nature of the seller's assets and operations.

For example, the decisions that most significantly impact the economic performance of an entity that owns and operates a coal-fired power plant likely will differ from the decisions that most significantly impact the economic performance of an entity that owns and operates a wind farm. A purchaser's involvement in the design of entities that own and operate renewable energy technologies may be an important factor to consider in evaluating whether the offtaker meets the power criterion. See Question 6.3.70 for discussion of this criterion involving an entity with restricted activities.

A purchaser that takes on a majority of the risk of the seller's assets over their remaining economic lives through an offtake arrangement may meet the power criterion. If so, it would be the primary beneficiary of the seller in which it holds a variable interest. The purchaser would likely remain the primary beneficiary until it ceases to be exposed to a majority of the risk of the seller's assets over their remaining economic lives, which may occur before the offtake arrangement terminates or is modified.

Question 6.3.230**

How does an enterprise evaluate whether a manager or the board of directors has the power over the activities that most significantly impact a VIE's economic performance?

Background: An entity may have governing provisions under which a board of directors is elected by equity holders and the day-to-day activities of the entity are carried out by a manager that the board cannot remove during the contract term (e.g. a general partner or outsourced operations manager). Judgment is often required to determine whether the manager or the board of directors has the power over the activities that most significantly impact a VIE's economic performance.

If the outsourced manager does not have a variable interest in the entity, it cannot have the power to direct the entity's most significant activities (see Question 6.2.80). See Question 4.4.140 concerning whether an equity-at-risk group has the power to direct the most significant activities through the right to elect a board of directors.

Interpretive response: To determine the level at which the power is exercised (i.e. at the board or manager level) an enterprise evaluates at which level decisions are made and whether board decisions sufficiently constrain the manager's decision making or provide the manager latitude to make significant decisions without board approval.

The evaluation often involves determining whether the board has the power to direct the entity's most significant activities through the operating and/or capital budgeting process. The relevant factors to consider when determining whether the board of director has power over the outsourced manager are:

— budget approval process;
— granularity of the budget approved by the board;
— the board's process and frequency of monitoring the budget;

- the board's approval process for deviations from the budget and level of deviations that require board approval;
- board approval of certain expenditures or customer and supplier contracts; and
- ability to make changes to the budget.

For example, if the board-approved budget is at a high level such that the manager has broad authority on the types of expenditures and activities it can undertake, the manager may not be constrained by the board and have the power to make the most significant decisions.

In contrast, if the budget is approved at a more granular level the manager is constrained in its ability regarding the types of activities it can undertake. Further, the board may constrain the manager if the manager is required to seek board approval for deviations from the budget or certain transactions. There are no bright line quantitative thresholds to determine whether an approval threshold is granular enough to constrain the manager's ability to make decisions, and therefore significant judgment is required.

6.4 Power criterion: Effect of participating rights and kick-out rights

Excerpt from ASC 810-10

20 Glossary

Kick out rights (VIE Definition) - The ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE's economic performance or to dissolve (liquidate) the VIE without cause.

Participating rights (VIE Definition) - The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Variable Interest Entities

> Consolidation Based on Variable Interests

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.

When identifying the party with the power to direct the most significant activities, kick-out rights and participating rights are only considered if a single enterprise has the unilateral ability to exercise those rights and the rights are substantive. [810-10-25-38C]

Kick-out rights	Provide the holder discretion to remove the party with power or to dissolve the VIE
Participating rights	Provide the holder the ability to block or to participate in the actions through which an enterprise exercises power

For guidance on kick-out rights and participating rights in the context of VOEs, see chapter 5.

Question 6.4.10

Do all kick-out rights or participating rights affect the determination of which party meets the power criterion?

Interpretive response: No. To impact the primary beneficiary analysis, kick-out rights or participating rights must be:

- unilaterally exercisable (see Question 6.4.20); and
- substantive (see Questions 6.4.30 and 6.4.110).

In general, a substantive unilateral kick-out right over a VIE's decision-maker (see section 3.8.) is expected to provide power to the party that is ultimately able to direct the exercise of those rights. However, a unilateral participating right does not necessarily provide power to its holder (see Question 6.4.120).

Question 6.4.20

Is the evaluation of kick-out rights and participating rights different when determining whether an entity is a VIE vs when identifying the primary beneficiary?

Interpretive response: Yes. There is a difference in how kick-out rights and participating rights are evaluated when determining whether an entity is a VIE and when determining the primary beneficiary. [810-10-25-38C]

	VIE analysis	Primary beneficiary analysis
Kick-out rights, participating rights	Consider if exercisable by a **simple majority**	Consider only if **unilaterally exercisable** by a single party or related party group

For example, if a legal entity other than a limited partnership permits its equity-at-risk group to remove a decision-maker with a simple majority vote, the equity-at-risk group has the power to direct the entity's significant activities – i.e. the legal entity does not possess the second VIE characteristic.

However, if that legal entity is a VIE because it meets another VIE characteristic, the simple majority kick-out right would be irrelevant to identifying the primary beneficiary. In that case, if the decision-maker's fee is a variable interest, it likely consolidates the VIE despite the existence of the simple majority kick-out right (see Question 6.6.150).

For guidance on kick-out rights and participating rights when determining if an entity is a VIE, see section 4.4.

Question 6.4.30

How does an enterprise determine if substantive unilateral kick-out rights exist?

Interpretive response: To identify whether substantive unilateral kick-out rights exist, an enterprise should:

Step 1	Determine which enterprise meets the power criterion
Step 2	Determine if any party has the unilateral right to remove that enterprise

In Step 2, the enterprise needs to evaluate whether any particular rights represent kick-out rights. This process generally requires careful review and evaluation of the VIE's governing documents and other contractual arrangements. For kick-out rights to be considered substantive, there must be no significant barriers to their exercise (see Question 6.4.40). The party with kick-out rights must have the ability to exercise those rights if it chooses to do so. See Question 3.2.30 for additional guidance on evaluating whether terms are substantive.

In general, a substantive unilateral kick-out right over a VIE's decision-maker (see section 3.8.) is expected to provide power to the party that is ultimately able to direct the exercise of those rights (see Question 6.4.10).

Question 6.4.40

What are considered barriers to exercise when determining whether kick-out rights are substantive?

Interpretive response: Topic 810 does not provide specific examples of barriers to exercise when evaluating the power criterion.

However, the guidance discussed in section 5.2.20 may serve as a starting point when evaluating whether kick-out rights are substantive. As discussed in Question 5.2.170, one or more of the following factors may indicate that kick-out rights held by an LP in a VOE are not substantive. [810-10-25-14A]

- Kick-out rights subject to conditions that make it unlikely they will be exercisable – e.g. conditions that narrowly limit the timing of exercise or would be economically unfavorable for the party holding the rights.
- Financial penalties or operational barriers associated with dissolving (liquidating) the VIE or replacing the decision-maker being kicked out because these could act as a significant disincentive for dissolution (liquidation) or removal.
- The absence of an adequate number of qualified replacement decision-makers or the lack of adequate compensation to attract a qualified replacement.
- The absence of an explicit, reasonable mechanism by which the party holding the rights can exercise them.
- The inability of the party holding the rights to obtain the information necessary to exercise them.

Further, barriers to exercise for kick-out rights may differ from liquidation rights (which are evaluated in a similar manner to kick-out rights, see Question 6.4.80).

These factors are not exhaustive. Instead, all relevant facts and circumstances should be considered in determining whether kick-out rights or liquidation rights are substantive.

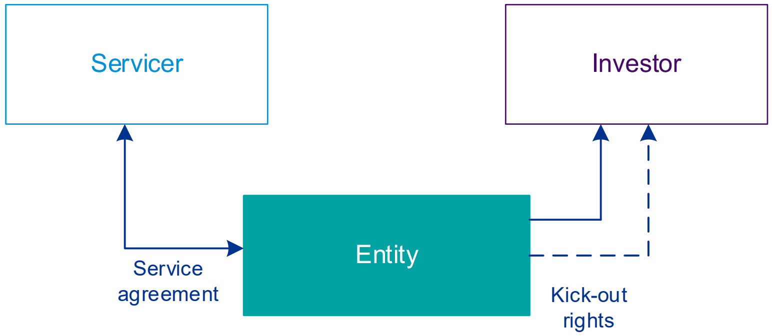
Question 5.2.180 provides guidance on how return-sharing provisions might affect the analysis of kick-out rights. Question 5.3.60 provides guidance on when a buy-sell provision may be like a kick-out right.

Example 6.4.10

Kick-out rights

Background

Legal Entity's servicer is deemed to control Legal Entity's most significant activities. Further, Investor must affirm in writing the appointment of Servicer on a monthly basis.



Evaluation

In this example, failure to affirm Servicer would result in Servicer's removal. The right to affirm Servicer on a monthly basis may not be described as a kick-out right in the contractual arrangements or governing documents. However, given the unilateral exercisability of this right, it should be considered one.

Question 6.4.50

When evaluating kick out rights, does the enterprise consider the nature of the party holding these rights?

Interpretive response: Yes. An enterprise considers the nature of the parties that hold the unilateral kick-out rights. The following are examples.

Kick-out rights may be provided to:	Based on its right to control:
— an equity investor — a significant investor in a VIE's non-equity instruments — a creditor — other stakeholder(s)	— the VIE's board of directors — a decision-maker or service provider

Certain enterprises may have a particular motivation to hold kick-out rights. Understanding the entity's purpose and design, including the risks the entity is designed to create and pass on to its variable interest holders (see section 3.3), may help identify these parties. Further, enterprises should evaluate whether parties holding kick-out rights are acting as an agent of another enterprise.

In general, a substantive unilateral kick-out right over a VIE's decision-maker (see section 3.8.) is expected to provide power to the party that is ultimately able to direct the exercise of those rights (see Question 6.4.10).

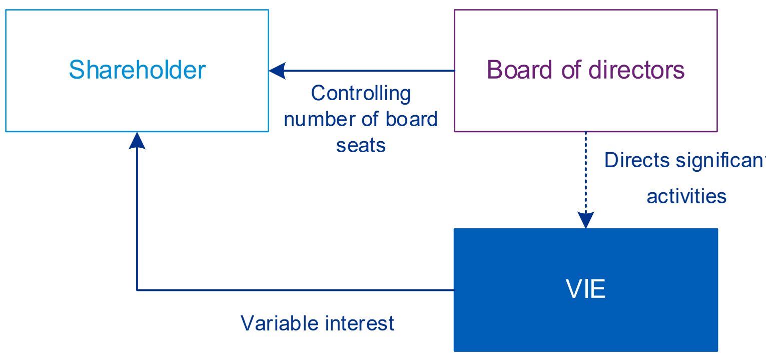
Question 6.4.60

Can a board of directors be evaluated as a single party when considering kick-out rights?

Interpretive response: No. A board of directors is a mechanism for shareholders to exercise their rights and therefore functions solely as a fiduciary of the shareholders. A board does not create new rights for shareholders. Instead, it is a reflection of, or pass-through mechanism for, the exercise of the shareholders' rights. Therefore, we believe that a board of directors cannot meet the power criterion. As a result, kick-out rights exercisable by a board should not be considered a unilateral right.

However, a single shareholder (or group of related party shareholders) may have the unilateral ability to select the requisite number of board members necessary to direct the board's actions.

The following diagram illustrates this arrangement.



In this example, if the board of directors makes decisions about activities that most significantly impact the economic performance of a VIE, the single shareholder (or group of related party shareholders) with the unilateral ability to control the board meets the power criterion.

See Question 4.4.140 for guidance on how to evaluate the rights of the board of directors when determining whether a legal entity is a VIE.

Question 6.4.70

Can an enterprise dispose of its kick-out rights?

Interpretive response: It depends. A transaction entered into by the enterprise to dispose of its kick-out rights must be substantive in nature (see section 3.2). The following are examples.

Likely not substantive	Potentially substantive
— An enterprise pledges not to exercise its kick-out rights. There is no apparent business reason for this pledge. — An enterprise transfers its kick-out rights to a third party for no consideration. There is no apparent business reason for this transaction.	A sponsor of an asset-backed securitization entity transfers its kick-out rights (e.g. the right to kick out the entity's special servicer) to a new institutional investor. In return, the new investor purchases securities issued by the entity. The institutional investor wanted power over the party that directs the VIE's most significant activities as a condition to making a large investment.

If there is no apparent business reason or purpose for a transaction, it is likely to be non-substantive. Non-substantive transactions may be structured in the hope of avoiding consolidation, and therefore should be ignored when applying the consolidation guidance. In contrast, an enterprise may have a valid business reason for transferring its kick-out rights to another party. An enterprise should consider all facts and circumstances when determining whether a transaction is substantive. See Question 3.2.30 for further guidance on evaluating whether a transaction is substantive.

Question 6.4.80

Does an enterprise consider dissolution or liquidation rights when identifying potential kick-out rights?

Interpretive response: Yes. The VIE consolidation model equates dissolution and liquidation rights with kick-out rights. When evaluating the primary beneficiary criteria, such rights must be unilaterally exercisable by a single enterprise or related party group (see Question 6.4.10) and substantive.

A substantive dissolution or liquidation right need only take power away from another party that would otherwise have it – e.g. a GP, managing member or decision-maker. It doesn't need to transfer this power over the VIE to its holder.

If an enterprise holds a substantive dissolution or liquidation right but is not entitled to receive the VIE's underlying assets upon exercise, the enterprise generally does not meet the power criterion. However, the existence of these rights precludes another enterprise from meeting this criterion. This is consistent with a substantive participating right (discussed in Questions 6.4.110 and 6.4.120).

In certain unusual circumstances, the liquidation of a VIE's assets could be the activity that most significantly impacts the VIE's economic performance. In that case, the holder of a substantive unilaterally exercisable liquidation right meets the power criterion – and may ultimately be the VIE's primary beneficiary.

The VOE consolidation model also equates dissolution or liquidation rights with kick-out rights. See Question 5.2.150 for guidance on evaluating those rights when identifying the party with the power to control a VOE.

Question 6.4.90

Should a withdrawal right be evaluated differently from a kick-out right?

Interpretive response: Yes. Withdrawal rights that do not either explicitly or implicitly require dissolution or liquidation are not similar to a substantive kick-out right (see Question 4.4.160).

However, in rare instances, withdrawal rights may implicitly require liquidation of a legal entity. These may function similarly to substantive kick-out rights given their ability to force a liquidation. For example, consider the following withdrawal right:

— a fund holds illiquid investments;
— one investor holds a substantial portion of the investment interests in the fund;
— the investor has the right to withdraw its entire investment upon notifying the fund;
— a withdrawal by the investor would compel the fund to liquidate all of its investments to satisfy the withdrawal right.

If there were no significant barriers to exercise, this withdrawal right would be similar to a substantive liquidation right, and therefore equivalent to a substantive kick-out right. See Question 4.4.160 for additional commentary about evaluating redemption rights, and Question 3.2.30 for guidance on evaluating whether terms are substantive.

Question 6.4.100

How should an enterprise evaluate a right that is exercisable at a future date?

Interpretive response: A right (e.g. kick-out, participating, liquidation, withdrawal) may become exercisable at a future date. This future date may be based on either the passage of time or on the occurrence (or nonoccurrence) of an event.

Evaluation of this right depends on how it is triggered.

After the passage of time	On the occurrence (or nonoccurrence) of an event
Consider these rights in the same manner as call options discussed in Question 6.4.130.	Consider these rights in the same manner as contingent power, discussed in Question 6.3.160.

See the following questions for additional guidance on each type of right.

Kick-out rights	Question 6.4.30
Dissolution and liquidation rights	Question 6.4.80

Withdrawal rights	Question 6.4.90
Participating rights	Question 6.4.110

Question 6.4.110

What constitutes a substantive participating right?

Interpretive response: The FASB provided no examples of what may constitute substantive participating rights when evaluating the power criterion.

Participating rights can provide a constraint on the decision-making ability of an enterprise in a manner similar to kick-out rights. Therefore, they are subjected to the same restrictions as kick-out rights (as discussed in Question 6.4.20). A participating right must be substantive to be considered in the primary beneficiary analysis.

The discussion in section 5.3 may serve as a starting point when evaluating whether participating rights are substantive. While the guidance in that section is in the context of limited partnerships, it also applies to entities that are not limited partnerships.

For VOEs, participating rights include, but are not be limited to, the ability to participate in such decisions as: [810-10-25-11]

- selecting, terminating and setting the compensation of the management responsible for implementing the policies and procedures; or
- establishing the operating and capital decisions, including budgets, in the ordinary course of business.

These rights may also represent participating rights for some VIEs if the activities subject to these powers most significantly impact the VIE's economic performance. This is more likely to be true for VIEs with substantive ongoing business operations than for other VIEs.

However, all facts and circumstances should be considered, including the level at which these powers operate. For example, the ability to approve operating and capital budgets may not remove power from the servicer of an asset management VIE if significant decisions about default mitigation cannot be significantly influenced through the budget process.

Ultimately, a substantive participating right in a VIE must provide the party holding it the right to participate in making the decisions that most significantly impact the VIE's economic performance (see section 6.3.20).

See Question 6.4.30 for guidance on substantive kick-out rights. See section 5.3 for additional guidance on substantive participating rights – including buy-sell dispute resolution provisions that are common in limited partnerships (see Question 5.3.60).

Question 6.4.120

Does an enterprise with substantive participating rights meet the power criterion?

Interpretive response: Not necessarily. Participating rights often do not provide their holder with the right to propose decisions or to unilaterally make decisions. Instead, they generally provide their holder with the right to approve decisions that are proposed by another party. Participating rights generally require at least two independent parties to agree to specified decisions that are made about an entity's activities. As a result, unlike a holder of a unilateral kick-out right (see Question 6.4.10), a holder of substantive participating rights may not meet the power criterion.

However, a substantive participating right may be a substantive kick-out right – e.g. when a dispute resolution provision includes a buy-sell provision that functions as a kick-out right (see Question 5.3.60).

Question 6.4.130

Does the holder of a call option on another party's variable interest meet the power criterion?

Interpretive response: It depends. Topic 810 does not address whether call options cause their holder to meet the power criterion. We believe the impact of a call option on this criterion depends on whether the call option is currently exercisable.

Option is currently exercisable	Option is not currently exercisable
Assuming there are no significant barriers to its exercise (financial or otherwise), it may cause the holder to meet the power criterion. This is because the call option may function similarly to a substantive kick-out right (Question 6.4.30). An enterprise does not have to exercise its power to meet the criterion (Question 6.3.150).	A call option that is not currently exercisable generally would not cause the holder to meet the power criterion.

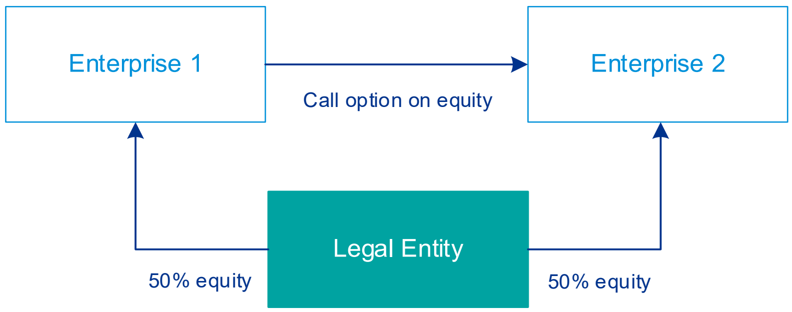
Deep-in-the-money call options that are currently exercisable for little consideration generally should be evaluated like substantive kick-out rights, because there is no barrier to exercise.

The accounting for a call option that does not cause the holder to meet the power criterion depends on whether the arrangement is a freestanding instrument or an embedded feature (see Question 5.2.40).

Example 6.4.20
Effect of call options on power analysis

Background

Enterprise1 and Enterprise2 hold 50% of Legal Entity equity. Enterprise2 has a call option on Enterprise1's equity.



Scenario 1 evaluation: call option currently exercisable

Enterprise2 holds a currently exercisable call option on Enterprise1's equity interest that is deep-in-the-money and exercisable for little consideration.

In this scenario, the call option is evaluated like a kick-out right that causes Enterprise2 to meet the power criterion. Power is not shared (see section 6.5.10).

Scenario 2 evaluation: call option not currently exercisable

Enterprise2's call option is not currently exercisable (e.g. not exercisable for five years) or is not exercisable unless Enterprise1 is acquired by a third party.

In this scenario, the call option generally does not affect the current analysis of power. When the call option becomes exercisable, its effect on the primary beneficiary evaluation needs to be reassessed.

Example 6.4.30**
Disposal of a subsidiary subject to repurchase option

ABC Corp. sells 100% of subsidiary XYZ Corp. to Buyer for a nominal amount ($1) to exit its operations in a country subject to political uncertainty and legal restrictions/sanctions. ABC retains a fixed-price call option to reacquire XYZ. The option is exercisable beginning on the first anniversary of the sale through the tenth anniversary.

ABC retains no other interests in XYZ. Buyer is restricted from selling, transferring or encumbering its shares in XYZ during the ten-year period without ABC's approval. The call option only provides ABC with protective rights in XYZ.

ABC evaluates whether to continue to consolidate XYZ after the transaction.

Is ABC's call option a variable interest?

Yes. Although ABC does not directly own shares in XYZ, ABC absorbs XYZ's positive variability through the fixed-price call option, which is a variable interest.

In contrast, if ABC had the option to purchase XYZ at fair value, the call option would not be a variable interest because the price would fluctuate with XYZ's fair value and no further analysis would be required. However, if the call option were based on a formula (e.g. a fixed multiple of EBITDA), it generally would not be considered a fair value option and would be a variable interest similar to a fixed-price option.

Is XYZ a VIE?

Yes. Buyer's investment of $1 is not substantive and therefore XYZ has no equity at risk and is a VIE (see Question 4.3.30).

In contrast, if Buyer's investment were substantive, further analysis would be needed to evaluate whether the fixed-price call option makes XYZ a VIE. A call option may not preclude an equity investment from being considered at risk. However, as described in Question 4.3.140 the features of the investment and/or option pricing (e.g. whether the option is deep in the money) could affect the determination of whether the equity is at risk. See Question 4.6.20, which discusses how call options on an equity-at-risk holder's equity do not typically trigger the Fourth VIE characteristic.

Is ABC the primary beneficiary at the transaction date?

Likely not. ABC's only rights in addition to the call rights are considered protective. Therefore, whether ABC meets the power criterion depends on whether the call option functions similarly to a substantive kick-out right (see Question 6.4.30). Because the option is not currently exercisable for one year, at the transaction date ABC generally would not meet the power criterion. However, when the option becomes exercisable ABC needs to reevaluate this determination (see Question 6.7.20) and consider whether there is a barrier to exercise due to the price or consider other factors such as the practical or legal ability to acquire XYZ in the current environment.

If the option was considered to be 'deep-in-the-money', ABC would likely consolidate when the option became currently exercisable.

Buyer also would likely be a de-facto agent because of the transfer restrictions (it cannot sell, transfer or encumber its interest XYZ without ABC's approval; see Question 6.5.120) or because it received its interest in XYZ from a contribution (see Question 6.5.100). Therefore, if Buyer is the single decision-maker but not the primary beneficiary because it does not meet the significant variable interest criterion, ABC may be the primary beneficiary if substantially all the activities are conducted on its behalf (see Question 6.5.180).

6.5 Power criterion: Shared power and related parties

6.5.10 Shared power and distributed power

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

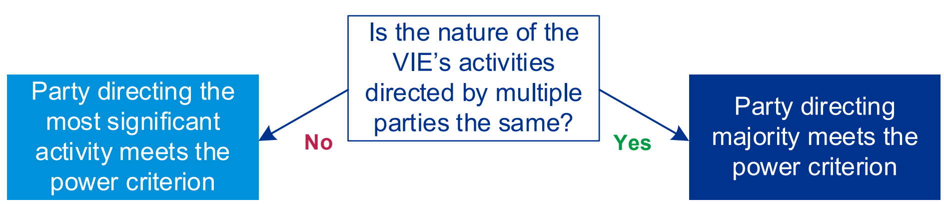
25-38D If a reporting entity determines that power is, in fact, shared among multiple unrelated parties such that no one party has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then no party is the primary beneficiary. Power is shared if two 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).

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

If multiple parties have the power to direct the activities of a VIE, further evaluation is needed to determine which party (if any) meets the power criterion.

'Shared power' means that all of the decisions that most significantly impact the VIE's economic performance require the consent of more than one party. When shared power exists for unrelated parties, no party is the primary beneficiary and no party consolidates the VIE. [810-10-25-38D]

Power can also be distributed to multiple unrelated parties, but not shared. If multiple unrelated parties direct the activities of a VIE, then the nature of the activities directed by each party drives the evaluation of the power criterion. [810-10-25-38D – 25-38E]



Question 6.5.10

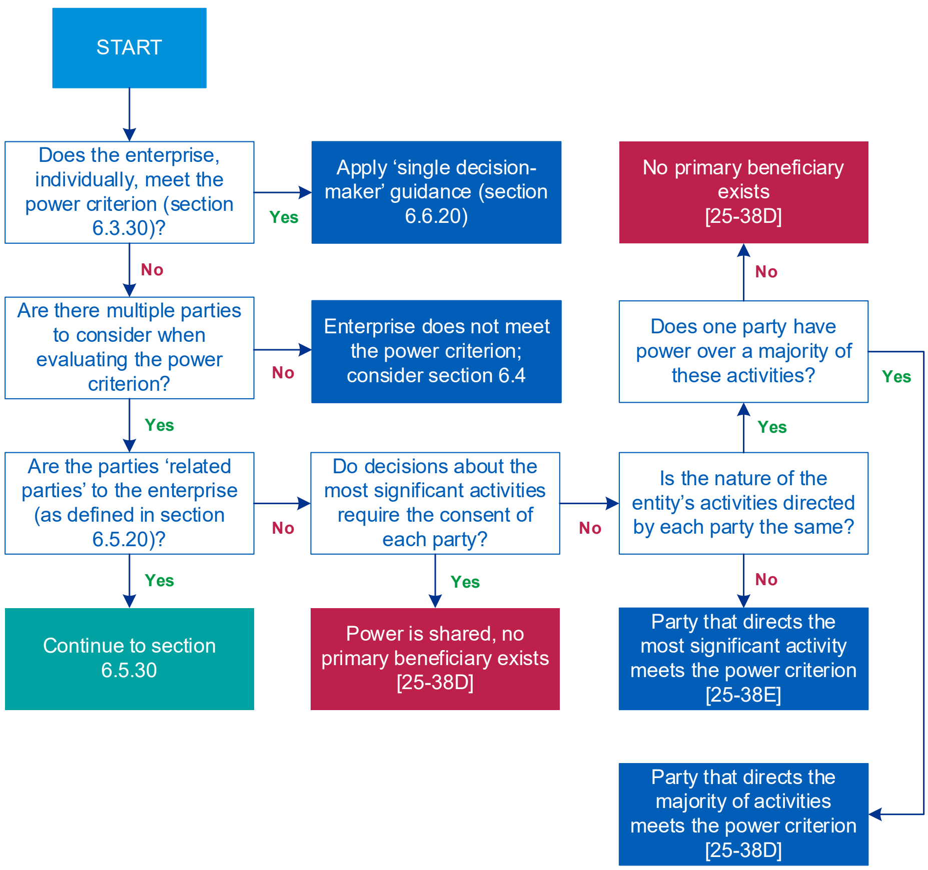
What does 'shared power' mean and what is the impact on the primary beneficiary determination?

Interpretive response: Power is shared if: [810-10-25-38D]

— two or more unrelated parties together meet the power criterion; and

— all decisions about the VIE's most significant activities require the consent of each party (i.e. one party cannot unilaterally make decisions related to the VIE's most significant activities).

The following decision tree illustrates the impact to the primary beneficiary analysis when power is potentially shared.



Question 6.5.20

Is the existence of a consent requirement sufficient to conclude that shared power exists?

Interpretive response: No. The requirement to obtain the consent of each party is indicative that a group of parties has agreed to share power. However, the mere existence of a consent requirement is not sufficient to conclude that shared power exists. An enterprise should carefully evaluate the VIE's governing documents to determine whether such consent provisions are substantive – e.g. what the consequences are if consent is not given. See Question 6.5.30 for additional discussion.

The SEC staff has commented that it views assertions of shared power with healthy skepticism (see below); therefore, registrants need to be prepared to support their assertions. [2010 AICPA Conf]

Excerpt from SEC staff speech

One of the more frequently arising points that we have considered is whether power in a particular instance is shared among multiple unrelated parties, such that no one party has the power to direct the activities of the entity that most significantly impact the entity's economic performance. The guidance is clear that power is shared if - and only if - two or more unrelated parties together have the power to direct the activities of a variable interest entity that most significantly impact the variable interest entity's economic performance and if decisions about those activities require the consent of each of the parties sharing power. We approach assertions that power is shared with a healthy dose of skepticism. The guidance sets up a model where both parties together have the power to direct the activities, with the consent of the other. It is important to read those words plainly and in a manner reflecting a concern that the concept could be interpreted more broadly than intended.

So, just to describe two situations at different ends of a spectrum: on the one end, we objected to a determination that power was shared between a sponsor and various unrelated investors where a sponsor transferred assets and the entity's investors purchased interests backed by those assets without any demonstration that the sponsor and investors agreed to share power over the entity's activities. On the other end, we also considered determinations that power was shared between two parties, where each party demonstrated that they together shared power.

Wesley R. Bricker, Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments

Question 6.5.30

How are deadlock provisions considered in determining whether there is shared power?

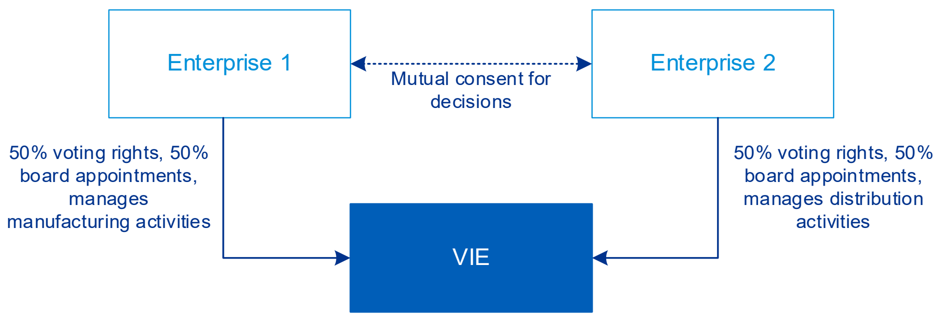
Interpretive response: An enterprise should carefully scrutinize provisions that address what happens when the parties sharing power cannot reach agreement on a decision relative to the VIE's activities. These are commonly referred to as 'deadlock provisions'.

For example, if one party is able to overcome the deadlock by casting a tie-breaking vote, that party may be the VIE's primary beneficiary. A single party's ability to cast a tie-breaking vote indicates that power is not truly being shared.

Example 6.5.10
Shared power

Background

Enterprise1 and Enterprise2 are unrelated parties that establish VIE to manufacture, distribute and sell a soft drink.



All decisions about the manufacturing, selling and distribution of the soft drink, which are the activities deemed to most significantly impact VIE's economic performance, require the consent of both Enterprise1 and Enterprise2.

Evaluation

Based on a consideration of these particular facts and circumstances, VIE does not have a primary beneficiary because the decisions about the activities that most significantly impact its economic performance are shared by Enterprise1 and Enterprise2.

Question 6.5.40
For multiple unrelated parties to share power, must each party have a similar level of economic interest in the entity?

Interpretive response: Not necessarily. Assuming each unrelated party's stated power is substantive, the parties' economic interests are not required to be proportionate. All facts and circumstances should be considered in evaluating whether power is shared.

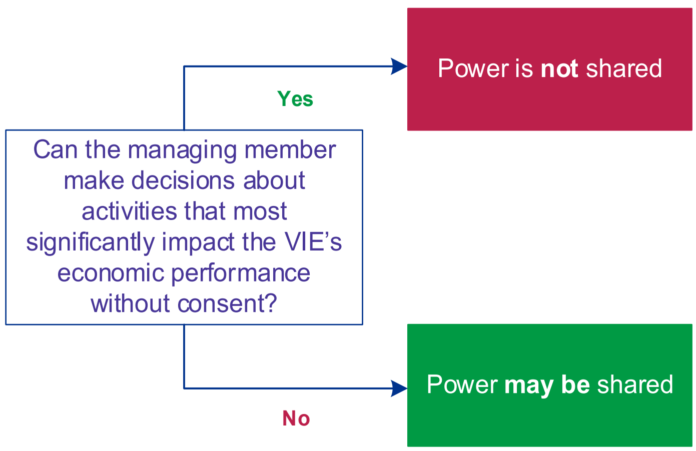
An increased level of skepticism is needed if a party's economic interest in a VIE is disproportionately greater than its stated power. Therefore, it is important to evaluate whether a party has a different degree of power over an entity compared with its proportion of economic interest in an entity.

See section 6.6.30 for additional guidance on disproportionality in the primary beneficiary analysis.

Question 6.5.50

What is the effect on a shared power analysis when one of the parties with shared power is also the managing member?

Interpretive response: It depends. The ability for a managing member to make key decisions about the VIE's activities will impact the shared power analysis as follows.



Many joint venture agreements appoint one of the members as the managing member to run the day-to-day operations of the joint venture. The managing member is not required to consult with the other member on a daily basis.

However, the managing member is typically required to carry out the annual operating plan as approved by the board of directors (which has equal representation). The assessment of shared power should focus on whether the decisions about the activities that most significantly impact the entity's economic performance are made either:

— with the consent of each member; or
— unilaterally by the managing member.

If all activities that most significantly impact the entity's economic performance are agreed on in the operating plan, it is appropriate to conclude that the managing member is carrying out the wishes of all members through their representation on the board of directors (in an agency capacity). Therefore, shared power may be present.

However, if decisions about some of the activities that most significantly impact the entity's economic performance may be made unilaterally by the managing member, power is not shared. In that case, the managing member would meet the power criterion. If the managing member also meets the significant variable interest criterion (see section 6.6), it is the primary beneficiary.

Example 6.5.20

Effect of a managing member on a shared power analysis

Background

Enterprise1 and Enterprise2 form VIE to develop, build and distribute super widgets. Enterprise1 is the managing member of the venture. Manufacturing and distribution of the super widgets are the activities that most significantly impact VIE's economic performance.

Evaluation

Although all other decisions of VIE require the consent of both Enterprise1 and Enterprise2, Enterprise1 as managing member unilaterally makes all decisions related to distribution activities. Because the decisions related to those activities are made unilaterally by Enterprise1 as managing member, power over VIE is not shared by Enterprise1 and Enterprise2. Therefore, Enterprise1 is the party that meets the power criterion.

Question 6.5.60

Does shared power exist if multiple unrelated parties direct a VIE's activities, and the nature of the activities directed by each party is the same?

Interpretive response: No. Shared power does not exist if multiple unrelated parties direct the VIE's most significant activities and the nature of the activities directed by each party is the same. When those circumstances exist, the enterprise that directs the majority of those activities meets the power criterion. [810-10-25-38D]

Determining which of multiple parties has power over the majority of a VIE's activities may be challenging and will require an enterprise to fully consider all relevant facts and circumstances. However, if no party has power over the majority of a VIE's activities when multiple parties make decisions about activities of the same nature, then the VIE has no primary beneficiary. [810-10-25-38D]

Question 6.5.70

Does shared power exist if multiple unrelated parties direct a VIE's activities but the nature of the activities directed by each party is different?

Interpretive response: No. Shared power does not exist if multiple unrelated parties direct the VIE's activities and the nature of the activities directed by each party is different. When those circumstances exist, the enterprise that directs the most significant activities meets the power criterion. [810-10-25-38E]

If that party also meets the significant variable interest criterion (see section 6.6), it is the VIE's primary beneficiary. A thorough understanding of the VIE's purpose and design, including the risks the entity is designed to create and pass on to its variable interest holders (see section 3.3), and any other relevant facts and circumstances is necessary when making this determination.

Question 6.5.80

Does shared power exist if some, but not all, significant activities require consent of two unrelated parties?

Interpretive response: No. Shared power does not exist if multiple unrelated parties must consent on some but not all of the decisions about the VIE's most significant activities. [810-10-25-38E]

The enterprise that directs the activities that most significantly impact the VIE's economic performance, both through unilateral and joint decision-making, is the enterprise that meets the power criterion (see Example 6.5.20).

This question has been addressed by the SEC staff in sharing its views about shared power analyses when the VIE has multiple significant activities (see below). [2014 AICPA Conf]

The SEC staff has also addressed a situation in which the most significant activities are limited. The example shared by the SEC staff was one in which a VIE was winding down due to the loss of its only customer and its most significant activities were limited to: [2020 AICPA Conf]

- approving the annual budget;
- approving suppliers used to fulfill the remainder of the contract; and
- appointing, removing or replacing the CEO.

These activities required a majority vote of the VIE's board of directors, but also required approval of both variable interest holders. In this example, the SEC staff did not object to the registrant's conclusion that power was shared.

Excerpt from SEC staff speech

The first issue I would like to discuss is the application of shared power. Topic 810 provides that no party is the primary beneficiary of a VIE when power to direct the significant activities of the entity is shared by multiple unrelated parties[1]. For purposes of illustration, assume an entity is owned equally by two unrelated parties and that there are three significant activities. Assume two of the three significant activities are "shared" in that decisions require joint consent of the owners, and that decisions regarding the third significant activity are unilaterally directed by only one of the owners.

In this example, while certain significant activities do require joint consent, it does not appear that shared power as described in Topic 810 exists[2]. For shared power to exist, the guidance seems to suggest that all decisions related to the significant activities of the VIE require the consent of each party sharing power[3]. When decisions related to a significant activity do not require joint consent, the staff has struggled to find a basis in the accounting literature to support that shared power can in fact exist. This is the case even when it is determined that the significant activities that require joint consent more significantly impact the economic performance of the entity than the significant activities that do not. In situations when shared power does not exist but multiple parties are directing different significant activities, the guidance provides that one party will meet the power criterion in the primary beneficiary assessment[4]. The staff believes an extension of this principle suggests that the party with more power, relative to others, over the significant activities of the VIE should consolidate[5]. In my example, a party's shared decision making rights over certain significant activities along with its unilateral decision making rights over the remaining significant activity seems to provide that party with a greater ability to impact the economic performance of the VIE compared to the other owner and therefore it should consolidate the VIE.

One final thought before moving on: determining what activities most significantly impact the economic performance of a VIE is a crucial first step in the primary beneficiary analysis that should take into account the purpose and design of the VIE and the risks and rewards that the VIE was designed to create and pass along to variable interest holders. This analysis often requires a significant amount of judgment. Keep in mind, decisions relating to activities that are not considered significant should not be considered in the primary beneficiary assessment. In my example, if the activity that is unilaterally directed by one owner was not considered a significant activity, shared power would in fact exist and no party would consolidate the VIE.

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1 The significant activities of a VIE are the activities that most significantly impact the VIE's economic performance.

2 ASC 810-10-25-38D provides that "[P]ower is shared if two or more unrelated parties together have the power to direct the activities of the 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."

3 Paragraphs A55 of the Basis for Conclusions to FASB Statement No.167, Amendments to FASB Interpretation No. 46(R), states, in part: "To the Board, it was important that decisions require the consent of each party sharing power because this would be most indicative of a group of parties that had agreed to share the power to direct the activities of a variable interest entity. The Board believes that situations in which decisions can be made without the consent of each party directing certain activities of the entity simply indicate that different parties have power over different activities, but those situations do not represent shared power over the entity."

4 Paragraph A56 of the Basis for Conclusions to Statement 167 states, in part: "The Board acknowledged that situations could exist in practice in which multiple parties are directing the activities that significantly impact the economic performance of the entity, but those parties do not need to consent to the decisions relating to those activities. The Board noted that such situations would not meet the definition of shared power… In the Board's view, if those parties are directing different activities, then the consolidation principle in [the VIE subsection of Topic 810] requires those parties to decide if they have power to direct the activities that have the most significant impact on the economic performance of the entity (that is, the application of the principle…would result in one of those parties having the [power characteristic])."

5 The Staff believes this is directionally consistent with the principle articulated in Case H4 in ASC 810-10-55-197 and 55-198 and in paragraph A57 of the Basis for Conclusions to Statement 167 which states, in part: "The Board also observed that, in practice, there could be situations in which the parties involved with an entity have power over different activities and portions of the same activities. The Board reasoned that, in those situations, an enterprise's power over certain activities, along with its power over portions of other

activities, might identify that enterprise as the party with the power to direct activities that most significantly impact the economic performance of the entity."

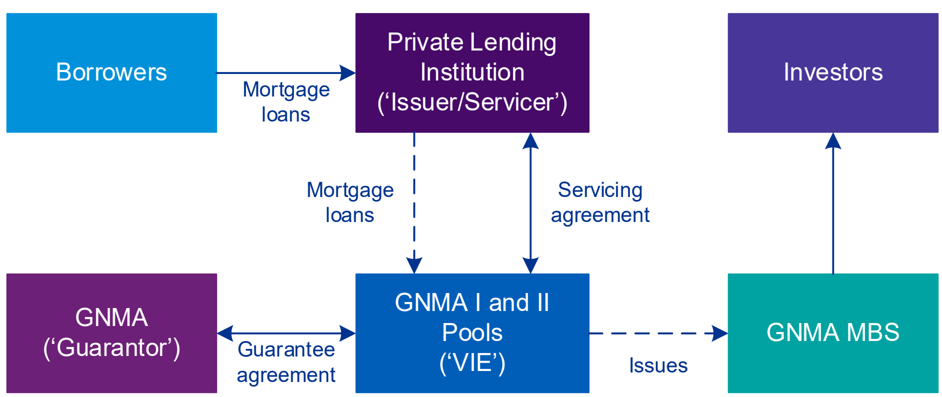
Christopher F. Rogers, Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments

Question 6.5.90

In a securitization of GNMA loans, which party is the primary beneficiary?

Background: Government National Mortgage Association ('GNMA') is a wholly owned corporate instrumentality of the United States within the Department of Housing and Urban Development. GNMA guarantees the timely payment of principal and interest on securities that are backed by pools of federally insured or guaranteed mortgages, primarily loans insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA), the Rural Housing Service (RHS), or the Office of Public and Indian Housing (PIH).

GNMA securitizations are different from typical MBS vehicles because there is no trust holding the mortgages backing the GNMA pass-through certificates. Rather, the GNMA MBS programs call for establishing custodial pools (i.e. GNMA I and II pools), whereby the issuer/servicer conveys to GNMA all rights, title, and interest to mortgages in the pool. GNMA does not purchase mortgage loans nor issue securities. Issuers, which are private lending institutions approved by GNMA, originate eligible government loans, pool them into securities, and issue GNMA MBS.



GNMA MBS are created when eligible mortgage loans (those insured or guaranteed by FHA, VA, RHS, or PIH) are pooled by approved issuers and securitized under guidelines issued by GNMA. GNMA MBS investors receive a pro rata share of the resulting cash flows (net of servicing and guarantee fees). GNMA itself does not issue securities, but instead guarantees the GNMA MBS issued by banks, thrifts and mortgage bankers that participate in GNMA's programs.

While a trust does not issue beneficial interests and does not hold the securitized assets like a typical securitization vehicle, we believe that GNMA I and GNMA II pools are legal structures created by legislation to conduct activities and hold assets and therefore meet the 810-10 Glossary definition of a legal entity. Further, we believe the pools are in the scope of the consolidation guidance. We do not believe the scope exception (which states that a reporting entity should not consolidate a governmental organization) applies to the GNMA MBS program. These conclusions were subject to consultation with the SEC staff and it did not object to them.

Because GNMA I and GMNA II pools are static vehicles that require all cash flows to be paid to the beneficial interest holders as principal and interest – i.e. the beneficial interests in the pools would be reported as debt on each pool's balance sheet – they have no equity investment at risk and are considered VIEs.

The primary purpose of a GNMA Pool is to provide investors with the opportunity to invest in credit-protected mortgages and to provide cost-effective secondary market liquidity for FHA and VA loans. This mechanism provides issuers the ability to originate additional loans to low/moderate income households and veterans. The design of the entity also provides a servicing fee for the issuer/servicer. However, the servicing fees are not a primary purpose of the entities because the issuer/servicer is entitled to those benefits before the transfer.

The MBS transactions are marketed to potential investors as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of FHA/VA, the issuer, and GNMA, and prepayment risks associated with the underlying mortgage loans.

Interpretive response: This guidance is based on dialogue with the SEC staff in connection with a letter submitted by the Mortgage Bankers Association of America (MBA). As part of the conclusion of this pre-clearance, the MBA submitted a confirmation letter dated February 10, 2010 to the SEC staff summarizing the SEC staff's conclusion. In the confirmation letter, MBA clarified its understanding that the conclusions apply only to GNMA I and GNMA II pools and should not be analogized to other situations.

Identification of variable interests

The parties involved with the VIE, and their respective variable interests, are as follows.

MBS Investor	— Absorbs substantially all prepayment risk and the minor risk of guarantor default
FHA, VA, and GNMA	— Guarantees the principal and interest of the GNMA MBS
Issuer/ Servicer	— May be an investor in the MBS, which subjects it to the risks noted above — The servicing fee may be a variable interest — Commonly has an option to repurchase defaulted receivables from the GNMA pools — May have an obligation for standard representations and warranties

Analysis of power criterion

The activities that most significantly impact the VIE's economic performance are management of credit risk, and to a lesser extent, prepayment risk. The authority of the various parties over these activities is as follows:

MBS Investor	— Has no power to direct the activities that impact credit or prepayment risk
FHA, VA and GNMA	— Set the guidelines for servicing, including forbearance, foreclosure and collection processes – i.e. involved in the design of the entity — Can change these guidelines as they see fit
Issuer/ Servicer	— Must service delinquent mortgages and manage foreclosure, collection and assignment procedures under the requirements of the FHA, VA and GNMA — Discretion is limited to that permitted by the guides of GNMA and the insuring/guaranteeing agencies (which can change at the discretion of those agencies)

Power considerations

Because multiple parties are involved in different activities that impact the VIE's economic performance (management of credit risk), determination of which of these activities most significantly impact the VIE's financial performance is required. Only one party can be determined to have this power.

For this determination, the various governmental organizations and GNMA are analyzed together because they are considered to be related because of their governmental nature.

FHA, VA and GNMA	Issuer / Servicer
— Control the design of the VIE — Dictate the quality and the nature of the collateral — Require the underlying insurance — Set the prescriptive servicing guides that the issuer/servicer must apply — Can also change these guides at will	— Selects the specific loans for each pool — Makes decisions within the narrow parameters of the servicing guides — Decides whether to exercise the call option for defaulted mortgages

When consulted, the SEC staff did not object to the conclusion that the issuer/servicer is not the primary beneficiary of these entities. This was because the governmental entities' control over the prescriptive servicing guidelines gives them power over the management of those activities that most significantly impact the VIE's economic performance.

6.5.20 Identifying related parties and de facto agents

Excerpt from ASC 810-10

20 Glossary

Related party – Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Variable Interest Entities

> Consolidation Based on Variable Interests

>> The Effect of Related Parties

25-43 For purposes of applying the guidance in the Variable Interest Entities Subsections, unless otherwise specified, the term *related parties* includes those parties identified in Topic 850 and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder. All of the following are considered to be de facto agents of a reporting entity:

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

have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.

1. Subparagraph superseded by Accounting Standards Update No. 2009-17
2. Subparagraph superseded by Accounting Standards Update No. 2009-17

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

Interests in a VIE held by parties related to an enterprise can affect whether the enterprise (or one of the related parties) is the VIE's primary beneficiary. Section 6.5.30 explains how related parties are considered in the primary beneficiary analysis.

Related parties include those contemplated in Topic 850 (related party disclosures). However, the definition of related parties under Topic 810 also includes parties that act as de facto agents or principals of the enterprise. [810-10-25-43]

'Related parties' (Topic 850) + De facto agents or principals = 'Related parties' in VIE model

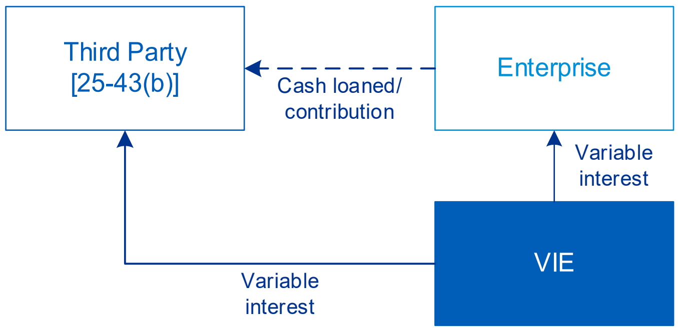
Determining whether an entity is a de facto agent or principal requires judgment. The following table explains the parties that are considered de facto agents of an enterprise. [810-10-25-43(a) – 25-43(e)]

De facto agent category	Description
'Key financial support' de facto agent [810-10-25-43(a)]	Party is a de facto agent if it cannot finance its operations without subordinated financial support from the enterprise – e.g. another VIE in which the enterprise is the primary beneficiary
'Loan / contribution' de facto agent [810-10-25-43(b)]	Party is a de facto agent because it received its interests in the legal entity being evaluated as a contribution or loan from the enterprise (see Question 6.5.100)
'Officer, employee or member of governing board' de facto agent [810-10-25-43(c)]	Party is an officer, employee or member of the governing board of the enterprise
'Prior approval of sale right' de facto agent [810-10-25-43(d)]	Party is subject to an agreement under which it cannot sell, transfer or encumber its interest in the legal entity without the enterprise's approval (see Question 6.5.120)
'Close business relationship' de facto agent [810-10-25-43(e)]	Party has a close business relationship with the enterprise – e.g. party is a professional service provider and enterprise is one of its significant clients (see Question 6.5.110)

Question 6.5.100

Is a party a loan / contribution de facto agent if it received only a portion of its variable interests through a loan or contribution from an enterprise?

Interpretive response: Yes. The following diagram illustrates an arrangement in which a third party is a loan / contribution de facto agent of an enterprise.



A party that receives its interests as a contribution or a loan from an enterprise is a de facto agent of that enterprise. This is the case regardless of whether the loan or contribution from the enterprise provided the party with all or a portion of its interests in a VIE. [810-10-25-43(b)]

Question 6.5.105

Is a party a loan/contribution de facto agent if it must (or may) sell its variable interest to the enterprise?

Interpretive response: It depends. If it is determined that the buyout arrangement is like a loan, it would create a loan/contribution de facto agent relationship between the parties.

However, not every buyout arrangement is like a loan. For example, the SEC staff did not object to an enterprise concluding that its buyout arrangement did not create a loan/contribution de facto agency relationship with the party holding the instrument based on the following facts and circumstances: [2020 AICPA Conf]

- the party's variable interest in the entity (subject to the buyout) was not initially financed by the enterprise;
- the party had held its variable interest since the VIE's inception and before the enterprise obtained its variable interest;
- the party did not need a loan to continue participating in the business; and
- the purpose of the buyout was to facilitate the VIE's impending dissolution.

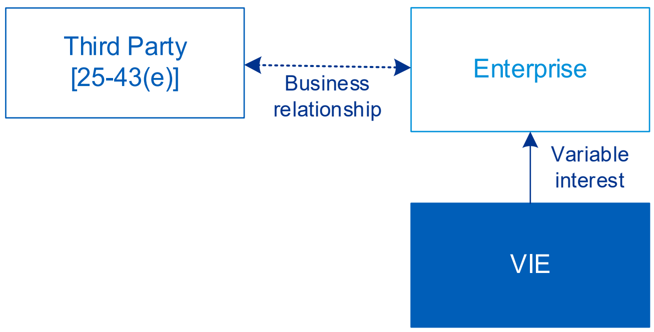
Whether a buyout arrangement is like a loan requires careful evaluation of the specific facts and circumstances and can be a very difficult judgment.

Question 6.5.110

When is a party a close business relationship de facto agent?

Interpretive response: Having a close business relationship may create a de facto agency relationship. This provision was included to avoid structuring opportunities that might otherwise exist if third-party service providers were excluded from the consolidation analysis. [810-10-25-43(e)]

The following diagram illustrates an arrangement in which a third party is a close business relationship de facto agent of an enterprise.



Close business relationships are those between an enterprise and its professional service providers, such as: [810-10-25-43(e)]

— investment bankers, accountants, lawyers; or
— others that have had a significant level of involvement in structuring the entity or a transaction.

An enterprise should carefully evaluate its level of involvement with third-party professional service providers. If the VIE is a significant client to the service provider, it may indicate that a de facto agency relationship exists. This requires a critical evaluation of the specific facts and circumstances surrounding the enterprise's involvement with the VIE. In practice, this can be a very difficult judgment.

The SEC staff has commented on its views about what constitutes a close business relationship in the context of evaluating whether a legal entity has the fifth VIE characteristic – i.e. the disproportionality characteristic (see section 4.7) – see below. [2008 AICPA Conf]

Excerpt from SEC staff speech

In the context of [ASC paragraph 810-10-15-14(c)], the staff has been asked whether certain close business associates may be considered related parties under [ASC Topic 850][4] or [ASC paragraph 810-10-25-43]. In this context, the staff believes that close business associates may only be considered related parties if one party can control or can significantly influence the other party to an extent that one of the parties might be prevented from fully pursuing their own separate interest should that party choose to do so. That being the case, the mere past practice or future intent of close business associates to collaborate would be insufficient to conclude the parties are related. The staff believes that this is consistent with the definition of a related party included in [ASC Subsection 810-10-20].

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4 [ASC Topic 850, Related Party Disclosures

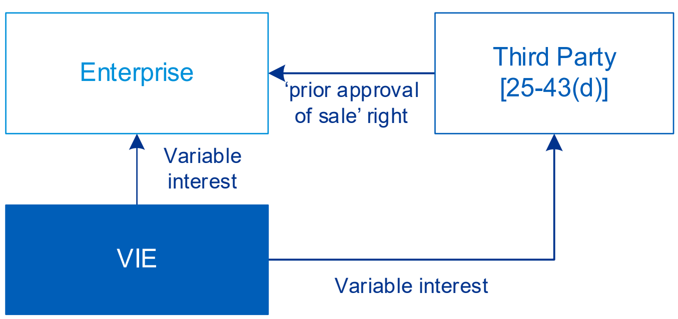
Robert B. Malhotra, Remarks before the 2008 AICPA National Conference on Current SEC and PCAOB Developments

Question 6.5.120

How is the phrase 'without the prior approval' evaluated when determining if a transfer restriction creates a de facto agency relationship?

Interpretive response: A de facto agent related party relationship exists when a party agrees not to sell, transfer or encumber its interests in the VIE without the prior approval of the enterprise. An agreement must restrict all three of these activities to result in a de facto agent related party relationship and may be referred to as a transferability restriction. For agreements where fewer than all three of these activities are restricted, see Question 6.5.140. [810-10-25-43(d)]

The following diagram illustrates an arrangement in which a third party is a without prior approval de facto agent of an enterprise.



Agreements that involve such restrictions may arise in certain operating entities such as partnerships and joint ventures, and in franchise arrangements. Whether such an agreement gives rise to a de facto agency relationship between the enterprise and the other variable interest holder depends on which contractual provisions the phrase 'without the prior approval' applies to.

The following are some common approval provisions and a discussion of whether they may give rise to a de facto agency relationship.

Approval provision	Description
Right of first refusal	Grants the holder the opportunity to accept an offer before that offer is accepted by another party.

<table>
<tr><th>Approval provision</th><th>Description</th></tr>
<tr><td></td><td>For example, Owner 1 (selling party) and Owner 2 (non-selling party) are co-owners of a joint venture:
— Each owner holds a right of first refusal.
— Owner 1 agrees with a third party (buyer) on the price and terms to sell its interest.
— Owner 1 must present to Owner 2 the option of purchasing its interest before selling to the buyer.
— Owner 2 can buy at the same price and terms that were agreed with the buyer.
This type of right does not restrict the variable interest holder's ability to sell or transfer its interest. It only provides the holder with an opportunity to meet the terms of an existing offer. Therefore, it does not create a de facto agency relationship.</td></tr>
<tr><td>Right of first offer</td><td>Grants the holder with the opportunity to receive an offer before that offer is made available to another party.
For example, Owner 1 (selling party) and Owner 2 (non-selling party) are co-owners of a joint venture:
— Owner 2 has a right of first offer.
— Owner 1 presents Owner 2 with an offer to sell its interest to Owner 2.
— Owner 2 has the option of accepting or rejecting the terms of the offer.
— If Owner 2 rejects the terms, it is considered to have provided its consent to Owner 1 to sell to a third-party buyer.
— The proposed sale must be at a price equivalent to or greater than those in the original offer – i.e. Owner 1 cannot sell its interest at any price or terms more favorable to the buyer than those included in the original offer to Owner 2.
The right of first offer may provide some limitations over which party the enterprise can sell its interest to. However, it does not create a de facto agency relationship because it does not restrict the variable interest holder's ability to sell or transfer its interest.</td></tr>
<tr><td>Approval not to be unreasonably withheld or delayed</td><td>A variable interest holder may have an agreement that it cannot sell, transfer or encumber its interests in the legal entity without the prior approval of another party, and this approval is not to be unreasonably withheld or delayed.
Because another entity has the ability to restrict the variable interest holder's ability to sell or transfer its interest, evaluating whether a de facto agency relationship exists will depend on a more in-depth analysis of the circumstances in which the other entity could withhold its approval (see Question 6.5.150), and whether it constrains the restricted party's ability to manage the economics of its interest (see Question 6.5.130). It cannot be presumed that a transfer restriction does not represent a constraint. An enterprise should consider all relevant facts and circumstances when making this determination.</td></tr>
</table>

Question 6.5.130

What is meant by 'constrain the restricted party's ability to manage the economic risks' in analyzing de facto agent relationships?

Interpretive response: The right of prior approval does not create a de facto agency relationship if that right does not constrain the restricted party's ability to: [810-10-25-43(d)]

— manage the economic risks; or
— realize the economic rewards from its interests in the VIE through the sale, transfer or encumbrance of those interests.

We understand the FASB intended this guidance to be interpreted similarly to the guidance in Topic 860 (transfers and servicing) about the ability of a transferee to pledge or exchange transferred financial assets.

Therefore, a de facto agency relationship is not created if a party has the ability to realize the economic benefits of its interest by obtaining substantially all of the cash flows of its interest without the other party's approval.

In our experience, the notion of 'substantially all' is interpreted under Topic 860 to mean 90% or more.

Question 6.5.140

How is an agreement that restricts a party's ability to realize some of the economic rewards from its interest evaluated?

Interpretive response: A de facto agency relationship does not exist if the party has the ability to realize the economic rewards from its interests. This ability can come from either selling, transferring or encumbering those interests. [810-10-25-43(d)]

The following are examples.

De facto agency relationship	Not a de facto agency relationship
An arrangement prohibits a party from encumbering its interest (but not from selling or transferring it). However, the party is already prohibited from selling or transferring its interest because of regulatory restrictions. A de facto agency relationship likely does exist in this situation. This is because of the other restrictions that were not imposed by the arrangement together with the restriction that was imposed by the arrangement.	A party is restricted from encumbering its interests in a VIE, but is permitted to sell or transfer those interests to realize its economic benefits.

A requirement for a party to obtain the enterprise's approval to transfer or encumber its interest likely would also create a de facto related party relationship. The term transfer as it used in Topic 860 (transfers and servicing) is generally equivalent to sale.

Enterprises should evaluate all facts and circumstances when determining whether restrictions on selling, transferring or encumbering an interest creates a de facto agency relationship.

Question 6.5.150

Does a transfer restriction create a de facto relationship if it only restricts an entity from selling its variable interest to a less qualified holder?

Interpretive response: A transfer restriction may be protective to the enterprise if the intention is not to constrain the restricted party in the manner discussed in Question 6.5.130.

A transfer restriction does not create a de facto agency relationship if: [FIN 46R.D43]

- the right of prior approval is designed solely to prevent transfer of the interest to a competitor or to a less creditworthy, or otherwise less qualified holder; and
- those parties are not the only potential purchasers of the interest.

Although FIN 46(R) is now superseded, we believe the FASB's intent has not changed and the above guidance is still relevant. To support a conclusion that there is no de facto agency relationship, the contractual provisions of the arrangement need to provide objective criteria to evaluate whether the potential transferee is less creditworthy or otherwise less qualified.

Question 6.5.160

Can a transfer restriction be circumvented by entering into a derivative contract?

Interpretive response: No. A party may be restricted from selling, transferring or encumbering its interest in a VIE. That party may decide to enter into a derivative contract to manage the economic risks and realize the economic reward of its interest. However, a party's ability to hedge its interest in a VIE does not, in and of itself, result in a conclusion that the restriction does not create a constraint. [FIN 46R.D44]

Question 6.5.170
Do substantive mutual transfer restrictions indicate a de facto agent relationship?

Interpretive response: No. Substantive mutual transfer restrictions do not cause the parties to the agreement to be de facto agents of each other, provided: [810-10-25-43(d)]

— the rights/restrictions are based on agreed terms; and
— the parties to the agreement are willing and independent.

However, a conclusion that a related party relationship does not exist does not eliminate the need for each party with a variable interest to determine whether it is the primary beneficiary.

6.5.30 Consequences of related party and de facto agency relationships

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

>> The Effect of Related Parties

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.

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.

25-44B This paragraph applies to a related party group that has the characteristics in paragraph 810-10-25-38A only when both of the following criteria are met. This paragraph is not applicable for legal entities that meet the conditions in paragraphs 323-740-15-3 and 323-740-25-1.

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

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

Pending Content

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

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~~ <u>criteria (a) and (b) below</u> are met. This paragraph is not applicable for legal entities that meet the conditions in ~~paragraphs 323-740-15-3 and~~ <u>paragraph</u> 323-740- 25-1.

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

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

One of the significant ways in which the VIE consolidation guidance differs from the VOE consolidation guidance is the impact of related parties. If related parties hold a variable interest in a VIE in which the enterprise also holds a variable interest, the enterprise is required to consider interests held by its related parties when applying the primary beneficiary criteria. When applying the primary beneficiary criteria, including variable interests held by its related parties may cause an enterprise to reach a different conclusion than it otherwise would have if it considered only its own interests in the VIE.

How related parties affect the primary beneficiary analysis depends on whether the VIE has a single decision-maker and if not, whether there is shared power within the related party group.

If…	Then…
Enterprise, **individually**, meets **both** the power criterion (i.e. single decision-maker) and the significant variable interest criterion (see section 6.6)	Enterprise (single decision-maker) is the primary beneficiary and consolidates the entity. [810-10-25-38A]
Enterprise, **individually**, meets **only** the power criterion (single decision-maker) **and** Enterprise and its related parties **under common control collectively** meet the significant variable interest criterion (see section 6.6)	The party in the group that is most closely associated with the VIE is the primary beneficiary. [810-10-25-43 – 44A]
Enterprise, **individually**, meets **only** the power criterion (single decision-maker) **and** Enterprise and its related parties that are **not under common control collectively** meet the significant variable interest criterion (see section 6.6)	No party in the group is the primary beneficiary unless substantially all of the VIE's activities are conducted on behalf of an individual party in the group other than the single decision-maker. If so, that party is the primary beneficiary. [810-10-25-44B]
Enterprise, **individually**, has the power to direct the most significant activities (single decision-maker) but its fee is not a variable interest **and** Enterprise and its related parties **collectively** meet the significant variable interest criterion (see section 6.6)	No party in the group is the primary beneficiary unless substantially all of the VIE's activities are conducted on behalf of an individual party in the group other than the single decision-maker. If so, that party is the primary beneficiary. [810-10-25-44B]
Two or more parties within the related party group have shared power and the related party group meets the significant variable interest criterion, but there is no single decision-maker (see section 6.6)	The party in the group that is most closely associated with the VIE is the primary beneficiary. [810-10-25-43 – 44A]
There is not shared power within the related party group	No party in the group is the primary beneficiary. [810-10-25-44B]

Question 6.5.180

When a related party group collectively meets the primary beneficiary criteria, which party consolidates the VIE?

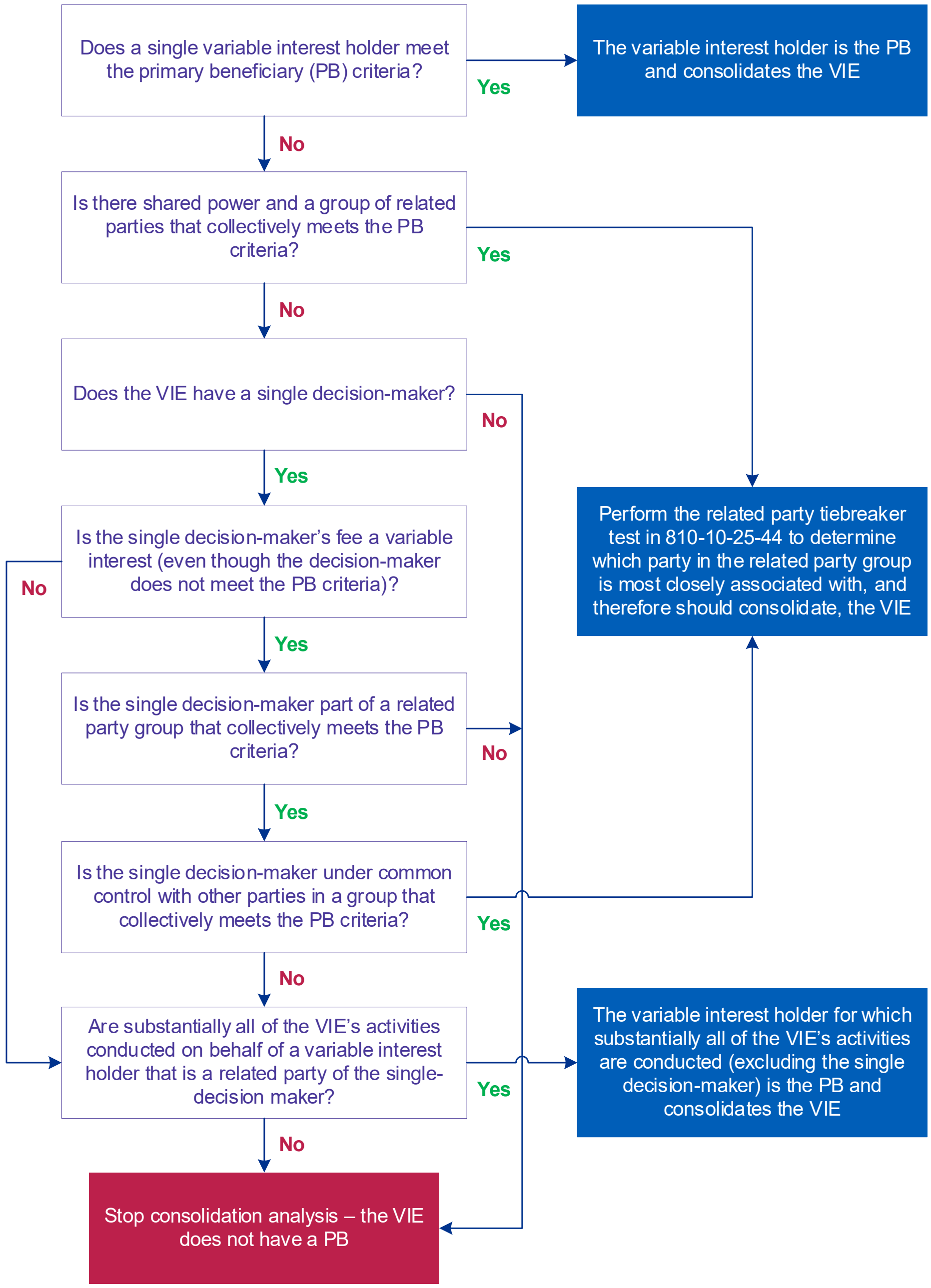
Interpretive response: It depends. The effect of related party relationships on the primary beneficiary determination depends on whether there is a single decision-maker and if not, whether there is shared power (see section 6.5.10) within the related party group.

If there is a variable interest holder that is single decision-maker and also meets the significant variable interest criterion, the single decision-maker is the primary beneficiary (see Question 6.2.40). Typically, a single decision-maker whose fee is a variable interest will also meet the significant variable interest criterion (see Question 6.6.150).

The following table summarizes how to identify the primary beneficiary in a related party group (if any).

When a related party group collectively meets the primary beneficiary criteria, the VIE will have a primary beneficiary in the following scenarios		**There is no primary beneficiary in the following scenarios**
Scenarios requiring the tie-breaker test[1]	Scenarios requiring the 'substantially all' analysis[2]	
— There is shared power within a related party group that collectively meets the primary beneficiary criteria; or — A single decision-maker whose fee is a variable interest does not meet the significant variable interest criterion, but its common control group does	— A single decision-maker's fee is not a variable interest and substantially all of the VIE's activities are conducted on behalf of another party in the single decision-maker's related party group; or — A single decision-maker whose fee is a variable interest does not meet the significant variable interest criterion, and substantially all of the VIE's activities are conducted on behalf of another party in the single decision-maker's related party group	— The VIE lacks both a single decision-maker and shared power within a related party group; or — A single decision-maker's fee is not a variable interest and substantially all of the VIE's activities are not conducted on behalf of another party in the single decision-maker's related party group
Notes: 1. Perform the related party tie-breaker test to determine which party in the related party group is most closely associated with, and should consolidate, the VIE. [810-10-25-44] 2. Determine whether substantially all of the VIE's activities either involve or are conducted on behalf of a single variable interest holder in the related party group. If so, that party is the primary beneficiary and consolidates the VIE. [810-10-25-44B]		

The following decision tree describes the effect of related parties on the primary beneficiary analysis. Question 3.8.230 provides guidance on the meaning of common control.



Question 6.5.190

Can a single decision-maker exist when power is shared?

Interpretive response: No. To meet the definition of a decision-maker, a party must have the contractual right to unilaterally make the decisions about one or more of the activities that most significantly impact a VIE's economic performance (see section 3.8.10). When there is shared power, decisions cannot be made unilaterally (see section 6.5.10). Therefore, a VIE cannot have a single decision-maker when there is shared power.

Question 6.5.200

Must an enterprise consider variable interests held by its related parties if does not hold a variable interest in a VIE?

Interpretive response: No. If an enterprise does not hold a variable interest in a VIE, it is not required to apply the VIE consolidation guidance (see Question 6.2.30). This is true even if the enterprise is a single decision-maker whose fee arrangement is not a variable interest in the VIE (see section 3.8 and Question 6.2.80).

However, an enterprise should carefully consider whether its related party or de facto agency relationships create an implicit variable interest (see section 3.5) before concluding that the guidance does not apply.

Question 6.5.210

What are some examples of a related party group collectively meeting the primary beneficiary criteria?

Interpretive response: The following are example situations in which a related party group collectively meets the power and significant variable interest criteria.

— One party in the related party group is the single decision-maker whose fee is a variable interest (i.e. has the power to direct the most significant activities). That party does not meet the significant variable interest criterion on its own. However, when considered collectively – i.e. all of the related parties' interests in the VIE are considered and not just the decision-maker's indirect interest through the related party – the related party group meets the significant variable interest criterion. [810-10-25-42]

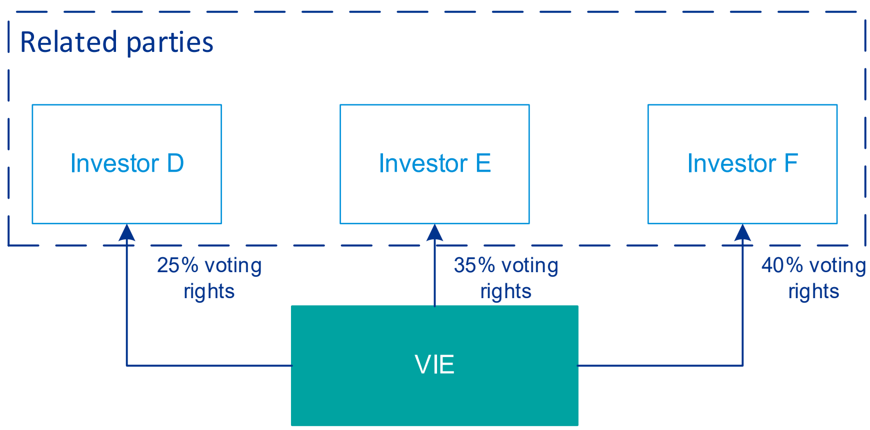
— Multiple related parties direct the activities that most significantly impact the economic performance of the VIE, and the nature of the activities that each party is directing is the same, but no party individually has power over a majority of these activities. The related party group collectively meets the significant variable interest criterion. [810-10-25-44]

See Question 6.5.180 for a decision tree that can be applied in reaching the primary beneficiary conclusions in these situations, and section 6.6 for additional guidance on how to apply the significant variable interest criterion.

Example 6.5.30
Entity controlled by voting interests

Background

VIE issues beneficial interests that carry substantive voting rights but are not considered equity under US GAAP. Decisions about the activities that most significantly impact VIE's economic performance require a simple majority vote of the voting interests. Consequently, two of the three parties must agree on all of the decisions that most significantly impact VIE's economic performance. All three investors are members of the same related party group.



Evaluation

None of the parties individually meets the criteria to be VIE's primary beneficiary. However, as a related party group, they meet the primary beneficiary criteria.

In this example there is no a single decision-maker. There is also no shared power (as defined in section 6.5.10) because the decisions about the activities that most significantly impact VIE's economic performance do not require consent from a group of two or more of the investors. Consequently, VIE is not consolidated by any of the variable interest holders.

Note: This conclusion does not depend on the nature of the related party relationship (e.g. whether the parties are under common control) because none of the parties are considered a single decision-maker. See Question 6.5.180 for the relevant decision tree.

Question 6.5.220

How does an enterprise determine whether substantially all of the VIE's activities either involve or are conducted on behalf of a variable interest holder?

Interpretive response: Evaluating whether substantially all of the VIE's activities either involve or are conducted on behalf of a variable interest holder in a related party group when determining the primary beneficiary is the same analysis that is performed when determining whether the entity is a VIE because an enterprise has disproportionately few voting rights and substantially all of the legal entity's activities are conducted on its behalf. Therefore, see Question 4.7.60 for considerations that should be included in the analysis.

Example 6.5.40

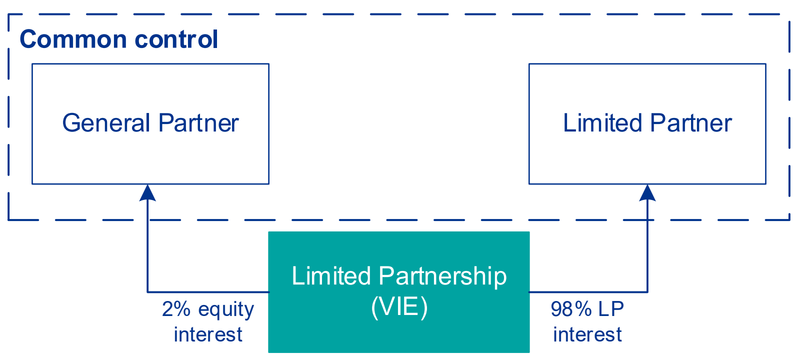
Determining the primary beneficiary in a common control group when the single decision-maker's fee is not a variable interest

Background

GP holds a 2% equity interest in Limited Partnership (VIE), and its decision-maker fee is embedded in its equity interest. GP's fee does not represent a variable interest (see Question 3.8.10).

One LP holds a 98% limited partnership interest. That LP lacks substantive participating rights or kick-out rights.

GP and LP are under common control (see Question 3.8.230), but neither holds an interest in the other.



Evaluation: GP

GP does not consolidate VIE because its decision-maker fee (which is conveyed through the equity interest) is not a variable interest (see Question 6.5.200). When the fee is not a variable interest, GP is deemed to be acting in a fiduciary capacity; therefore, GP does not meet the power criterion and cannot consolidate VIE.

The fact that LP is under common control with GP does not change GP's consolidation conclusion. GP does not perform the related party tie-breaker test because its fee is not a variable interest and therefore does not meet the power criterion (see Question 6.2.80).

Evaluation: LP

LP meets the significant variable interest criterion (see section 6.6). However, LP does not meet the power criterion. Generally, a limited partner should not consolidate a limited partnership that is a VIE if it does not meet this criterion, unless it is required to do so under the related party primary beneficiary requirements.

Because GP's fee is not a variable interest, LP does not perform the related party tie-breaker test (consistent with evaluating GP). However, because GP and LP are related parties, LP should consolidate VIE if substantially all of VIE's activities either involve or are conducted on its behalf (see Question 6.5.180). An exception to this rule is if LP is an investor in an affordable housing tax credit structure (see Question 6.5.330).

Evaluation: Parent company

The parent company of GP and LP is required to consolidate VIE in its consolidated financial statements because it meets both of the primary beneficiary criteria. This is the case regardless of whether GP or LP are considered the primary beneficiary in their separate financial statements.

See Example 6.6.60 for additional discussion of this fact pattern when the GP and LP are not related parties.

Question 6.5.230

Is it possible for an entity with multiple decision-makers to have a single decision-maker in the context of the related party guidance?

Interpretive response: Yes. It is possible for an entity to have multiple decision-makers under the definition of a decision-maker, but a single decision-maker when applying the related party guidance.

Decision-maker	A party that has the contractual right to unilaterally make decisions about one or more activities that significantly impact an entity’s economic performance
Single decision-maker	A party that has the power to direct the activities that most significantly impact economic performance

The party (if any) that individually has the power to direct the activities that most significantly impact a VIE’s economic performance is a single decision-maker. However, that party cannot meet the power criterion if its decision-maker fee is not a variable interest (see section 3.8) in the VIE. In that case, that party cannot be the primary beneficiary (see Question 6.5.200). Therefore, evaluating whether it is the single decision-maker does not affect its consolidation conclusion.

However, that decision-maker's related parties that have variable interests in the VIE must decide whether that enterprise, or another enterprise in the related party group, has the characteristic of a single decision-maker. The members of the related party group need to complete this analysis because whether the VIE has a single decision-maker in the related party group may affect which (if any) variable interest holder in that group consolidates the VIE. See Question 6.5.180 for the decision tree about how an enterprise should determine which party (if any) in a related party group should consolidate a VIE.

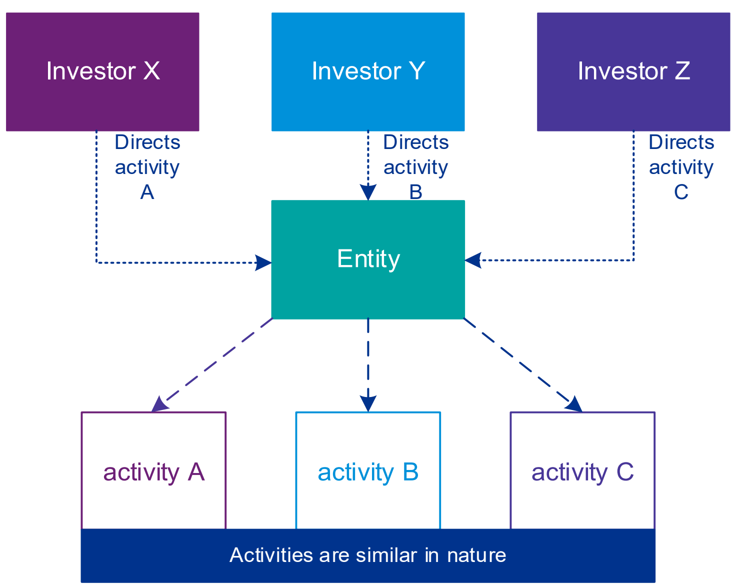
The guidance in section 6.5.10 on shared and distributed power addresses situations in which there are multiple unrelated parties that direct the activities that affect a VIE's economic performance. We believe that guidance may also be relevant for related party groups. Therefore, related party groups should apply these principles to:

- identify whether there is shared power within the group ; and
- evaluate whether there is one member of the related party group with distributed power that is considered a single decision-maker because it individually has the power to direct the most significant activities.

Example 6.5.50
Identifying a single decision-maker when power is distributed to multiple parties

Background

VIE has three activities that significantly impact its economic performance: activities A, B and C.



Evaluation

Investors X, Y and Z each meet the definition of a decision-maker and each have a variable interest. Given the activities are of the same nature, the guidance in section 6.5.10 requires a determination of whether one of the investors is directing a majority of the activities. If so, that investor individually meets the power criterion and is considered a single decision-maker when applying the related party guidance.

Alternatively, if the nature of the activities was not the same, the guidance in section 6.5.10 would require a determination of which activity most significantly impacts VIE's economic performance. The investor directing that activity would individually meet the power criterion and would be a single decision-maker when applying the related party guidance. For example, if activity A has a greater impact on VIE's economic performance than either activity B or activity C, Investor X would be considered a single decision-maker when applying the related party guidance.

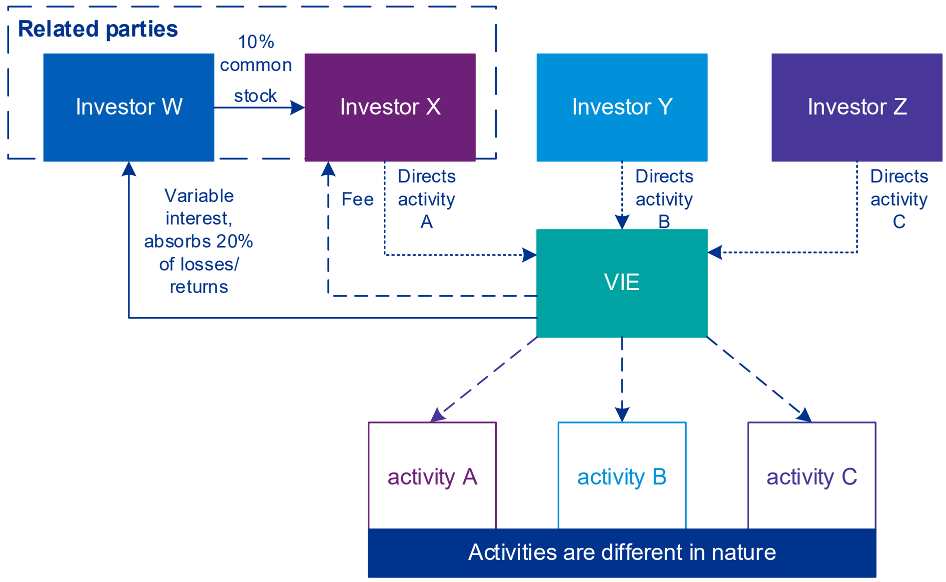
Example 6.5.60
Multiple unrelated decision-makers

Background

VIE has three activities that significantly impact its economic performance: activities A, B and C. Those activities do not have the same nature. Activity A has a more significant impact on VIE's activities than activity B or activity C.

Investors X, Y and Z are not related parties. Investor W is a related party with Investor X and holds a variable interest that absorbs 20% of VIE's expected losses and expected residual returns. Investor X owns 10% of the common stock of Investor W, and Investor X and Investor W are not under common control.

Investor X has a below-market fee that is a variable interest under the guidance in section 3.8.10. Investor X individually does not meet the significant variable interest criterion (see section 6.6).



Evaluation

Investor X individually meets the power criterion (see section 6.5.10) because:

- power is distributed to multiple unrelated parties that direct different activities; and
- it directs the activities that are most significant to VIE's economic performance.

Investor X is considered a single decision-maker in the context of the related party guidance. However, it does not individually meet the significant variable interest criterion (see section 6.6) and therefore does not individually meet the primary beneficiary criteria.

Investor W individually meets the significant variable interest criterion (see section 6.6). However, it does not individually meet the power criterion and therefore does not individually meet the primary beneficiary criteria.

Although neither Investor X nor Investor W individually meets the criteria to be VIE's primary beneficiary, they are in the same related party group that collectively meets the primary beneficiary criteria. However, the related party tie-breaker guidance does not apply because Investor X is considered a single decision-maker and is not under common control with Investor W.

In this example, VIE has a primary beneficiary only if substantially all of VIE's activities either involve or are conducted on behalf of Investor W. This is unlikely because there are multiple decision-makers, multiple different activities, and no indication that substantially all of the activities are conducted on the behalf of Investor W.

Alternatively, if Investor X and Investor W were under common control, the related party tie-breaker guidance would apply. The party most closely associated with VIE (which could potentially be Investor X) would be required to consolidate VIE.

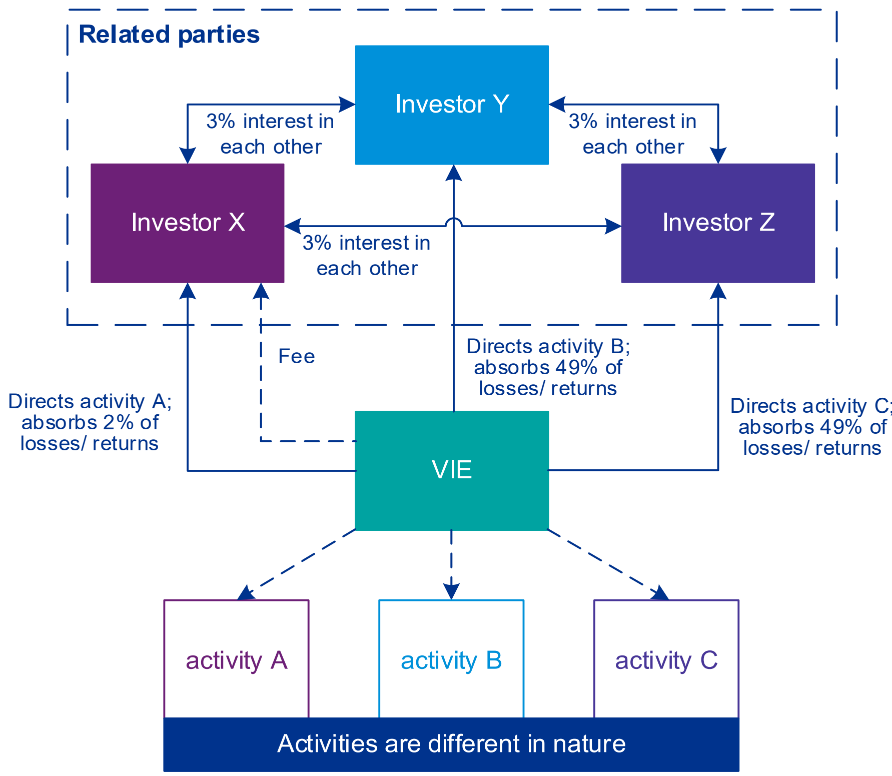
See Question 6.5.180 for the decision tree used in evaluating the fact pattern in this example.

Example 6.5.70
Multiple related party decision-makers

Background

Assume the same facts as Example 6.5.60, except for the following.

- Investor X, Y and Z are related parties not under common control.
- Each investor holds a 3% interest in each of the other investors.
- Investor X holds a direct variable interest that absorbs 2% of VIE's expected losses and expected residual returns.
- Investor Y and Z each hold a direct variable interest that absorbs 49% of VIE's expected losses and expected residual returns.



Evaluation

Investor X is the single decision-maker because it has the power to direct the most significant activities (by unilaterally directing activity A). However, it does not individually meet the significant variable interest criterion (see section 6.6.20). This is because Investor X's obligation to absorb losses and right to receive benefits from VIE would total only 4.94%, calculated as follows:

Direct interest	2.00%
Indirect interest through Investor Y (3% × 49%)	1.47%
Indirect interest through Investor Z (3% × 49%)	1.47%
Total	4.94%

Although none of the investors individually meets the criteria to be VIE's primary beneficiary, they are in the same related party group that collectively meets the primary beneficiary criteria.

The related party tie-breaker guidance does not apply because Investor X is considered a single decision-maker and is not under common control with the other investors.

In this example, VIE has a primary beneficiary only if substantially all of VIE's activities either involve or are conducted on behalf of Investor Y or Investor Z. This is unlikely because there are multiple decision-makers, multiple different activities, and no indication that substantially all of the activities are conducted on the behalf of Investor Y or Investor Z.

Alternatively, if Investor X was under common control (see Question 3.8.230) with Investor Y and/or Investor Z, the related party tie-breaker guidance would apply. The party most closely associated with VIE (which could potentially be Investor X) would be required to consolidate VIE.

See Question 6.5.180 for the decision tree used in evaluating the fact pattern in this example.

Question 6.5.240

What is the tie-breaker test, and when is it relevant to consider?

Interpretive response: The related party tie-breaker test is applied when an enterprise concludes that:

- neither it nor one of its related parties individually meets the primary beneficiary criteria; but
- its related party group does and:
  - there is shared power within the related party group; or
  - there is a single decision-maker whose fee is a variable interest, and the group is under common control (see Question 3.8.230).

In either of those scenarios, the party in the related party group that is most closely associated with the VIE is the primary beneficiary. Identifying the party that is most closely associated with the VIE is referred to as the tie-breaker test. This test requires judgment based on an analysis of all relevant facts and circumstances, including each of the following factors. [810-10-25-44]

The existence of a principal-agent relationship between parties in the related party group	**Questions 6.5.260 and 6.5.270**
The relationship and significance of the activities of the VIE to the various parties in the related party group	**Question 6.5.280**
A party's exposure to the variability associated with the anticipated economic performance of the VIE	**Question 6.5.290**
The design of the VIE	**Question 6.5.300**

The related party tie-breaker guidance is not required (or permitted) when:

— there is a single party in the common control group (see Question 3.8.230) that meets both of the primary beneficiary criteria; and
— stated power is substantive.

See Question 6.5.180 for a decision tree that can be applied in reaching the primary beneficiary conclusions in related party situations.

The SEC staff has reaffirmed that a tie-breaker test should be performed only when no party in the related party group individually meets the definition of a primary beneficiary (see below). [2014 AICPA Conf]

Excerpt from SEC staff speech

Finally, the last VIE consolidation topic I want to touch on today is how to consider power and economics when related parties are under common control. The staff has received several questions recently regarding whether the related party tie-breaker guidance always must be considered when determining which party in a common control group is the primary beneficiary of a VIE.[1] While common control arrangements do require careful consideration to determine if stated power is in fact substantive[2], the staff does not believe there is a requirement to consider the related party tie-breaker guidance or that that guidance is necessarily determinative unless no party in the common control group individually meets both characteristics of a primary beneficiary.

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1 ASC 810-10-25-44.
2 ASC 810-10-15-13A.

Christopher F. Rogers, Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments

Question 6.5.250

What is meant by 'most closely associated with' in the context of the tie-breaker test?

Interpretive response: Determining which party in a related party group is most closely associated with a VIE is generally a qualitative assessment. An enterprise should determine for which party the operations of the VIE are critical; this includes understanding the operations and the assets of the evaluating enterprise. This evaluation requires judgment based on an analysis of all relevant facts and circumstances. No one factor is determinative. Facts and circumstances will dictate how much emphasis can be placed on a particular consideration.

This is consistent with comments made by the SEC staff that it believes that all facts and circumstances should be considered in the overall assessment of which party is most closely associated with the VIE (see below). [2004 AICPA Conf]

Further, the SEC staff has reiterated the need to consider relevant facts and circumstances in determining which party is most closely associated with a VIE (see below). [2010 AICPA Conf]

Excerpt from SEC staff speeches

It is important to read the words in [ASC paragraph 810-10-25-44] plainly. [ASC paragraph 810-10-25-44] requires an overall assessment of which party is the most closely associated with the entity. When considering questions under [ASC paragraph 810-10-25-44], the staff considers all the factors in [ASC paragraph 810-10-25-44] and any other factors that may be relevant in making this overall assessment. We do not view [ASC paragraph 810-10-25-44] to be a matter of checking the boxes for the four factors listed and adding up who has the most boxes checked. Instead we look at all relevant factors in their entirety considering the facts and circumstances involved. We have also been asked whether any of the factors in [ASC paragraph 810-10-25-44] carry more weight than any others or whether any of the factors in [ASC paragraph 810-10-25-44] are determinative. There is no general answer to this question. Instead, the facts and circumstances of the situation should be considered to determine whether one factor or another is more important.

Jane D. Poulin, Remarks before the 2004 AICPA National Conference on SEC and PCAOB Developments

The determination of which member of a related party group is most closely associated with a variable interest entity generally is qualitative and dependent on the facts and circumstances. When determining which member is most closely associated with the variable interest entity, consider approaching the task plainly and with attention to the overall objective and control premise of the model.

Wesley R. Bricker, Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments

Question 6.5.260

What is considered when determining if a principal-agent relationship exists among members of a related party group?

Interpretive response: The first factor to consider in the related party tie-breaker guidance is the existence of a principal-agent relationship between the various parties in that related party group. For example, if one party acts as an agent of another party (the principal), this may indicate that the principal is most closely associated with the VIE because the agent is acting on the principal's behalf.

There are a variety of considerations that may need to be evaluated to determine whether a principal-agency relationship exists. See Question 6.5.270 for additional guidance.

Question 6.5.270

In evaluating the tie-breaker guidance, when does an agency relationship exist, and how is the principal identified in that case?

Interpretive response: The fact that an enterprise is a VIE's decision-maker often indicates that the enterprise may be a principal in an agency relationship. In our experience, the principal in an agency relationship is often most closely associated with the VIE.

Further, the de facto agent in a de facto agency relationship should be viewed as an agent under the related party tie-breaker guidance. This would apply, for example, if:

— Party A cannot sell, transfer or encumber its interest in the VIE without Party B's approval; but
— there is no corresponding requirement for Party B to obtain Party A's approval for Party B to sell, transfer or encumber its interest in the VIE.

In this example, Party A would be considered the agent and Party B the principal in a de facto agency relationship (see section 6.5.20) under the related party tie-breaker guidance. In that case, Party B may be most closely associated with the VIE.

Question 6.5.280

What is considered when evaluating the relationship and significance of the VIE's activities to the individual parties in the related party group?

Interpretive response: The second factor to consider in the related party tie-breaker guidance relates to the relationship and significance of the VIE's activities to the individual parties in the related party group.

Evaluating this factor should consider all relationships between the VIE and the parties in the related party group. The enterprise should consider all relevant facts and circumstances, including whether:

— any party in the related party group was significantly involved in the design or structuring of the VIE, including its primary purpose and operations;

— any party in the related party group has operations that are substantially the same as those of the VIE;

— the variable interest in the VIE represents a large percentage of the total assets of a party in the related party group;

- the products or services provided by the VIE are significant inputs to the operations of a party in the related party group – e.g. if a party outsources production to the VIE;
- a significant portion of the products of a party in the related party group are sold to the VIE and/or represent key inputs to the VIE's activities;
- any employees of a party in the related party group also manage the activities of the VIE;
- the compensation for the VIE's employees is tied to the operating results of any party in the related party group;
- a party in the related party group is required to fund the VIE's operating losses;
- a party in the related party group funds R&D that is significant to the VIE's operations;
- a large percentage of the VIE's assets has been leased to/from a party in the related party group; and
- any party in the related party group has the right (e.g. via a call option) to purchase the other parties' interests in the VIE or sell (e.g. via a put option) its interests to another party in the related party group.

Question 6.5.290

What is considered when evaluating the VIE's economic performance?

Interpretive response: The third factor to consider in the related party tie-breaker guidance requires an evaluation of the VIE's economic performance. When evaluating this factor, the enterprise should consider the extent to which each party in the related party group is obligated to absorb losses of the VIE or entitled to receive benefits from the VIE as a result of the VIE's economic performance. While enterprises are not required to perform detailed expected loss calculations, it may be helpful to perform one. This is particularly true if the qualitative factors do not clearly identify the primary beneficiary in the related party group.

If the variability absorbed by one party in a related party group significantly exceeds the variability absorbed by the other parties, that party may be the VIE's primary beneficiary. However, this is not always the case. The party ultimately identified as the VIE's primary beneficiary may not be the party in the related party group that has the most exposure to the VIE's variability. For example, a parent company and a subsidiary may form a related party group with respect to a VIE. The subsidiary may absorb a larger share of the VIE's variability through its variable interests than the parent company. The parent company may meet the power criterion. In this circumstance the parent company may be identified as the primary beneficiary because of its control over the subsidiary.

Question 6.5.300

What is considered when evaluating the design of the VIE?

Interpretive response: The last factor to consider in the related party tie-breaker guidance relates to the design of the VIE. When evaluating this factor, the enterprise should consider whether the VIE was designed or structured for the benefit or purpose of a particular party in the related party group.

Similar to the primary beneficiary analysis, a party's involvement in the design of a VIE may indicate that the party had the opportunity and the incentive to establish arrangements that result in that party most significantly benefiting from the arrangement. A securitization or other financing vehicle established by a transferor is an example of an entity structured for the benefit of a particular party (i.e. the transferor). See additional guidance at Question 6.3.140.

Question 6.5.310

How is the tie-breaker test applied if there is shared power between members of a related party group that collectively meets the significant variable interest criterion?

Interpretive response: When there is shared power within a related party group that collectively meets the significant variable interest criterion (see section 6.6), one of the parties in the group must be identified as the primary beneficiary of the VIE. In that situation, the related party tie-breaker guidance must be considered in identifying the party that is most closely associated with the VIE.

See section 6.5.10 for guidance on shared power and see Question 6.5.240 for guidance on the tie-breaker test.

Question 6.5.320

How is the tie-breaker test applied if each party in a related party group under common control has a variable interest in the VIE?

Interpretive response: When the parties in a related party group are under common control (see Question 3.8.230), consideration of substantive terms is key to the primary beneficiary assessment. This will be necessary in determining which party in the common control group is most closely associated with the VIE.

When evaluating substance in these situations, identifying whether the party that has the stated power has a disproportionately small economic interest in the entity relative to other parties in the common control group is particularly important.

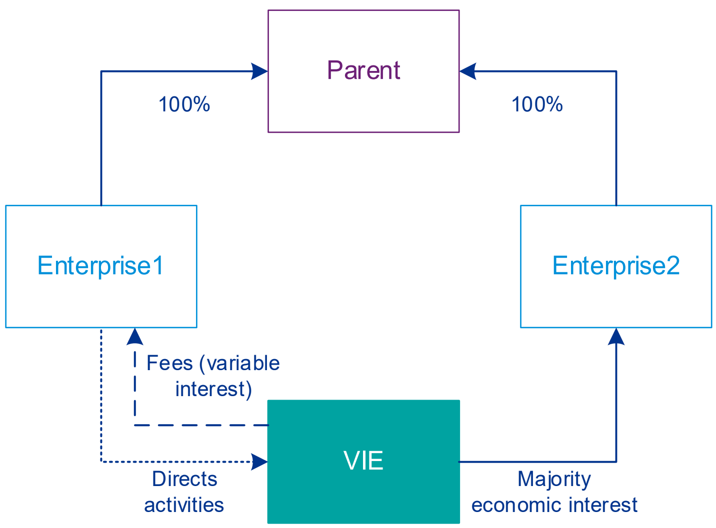
See Question 3.2.30 for guidance on evaluating whether terms are substantive and see section 6.6.30 for guidance on disproportionality in the primary beneficiary analysis.

Example 6.5.80
Determining the primary beneficiary in a common control group

Background

Enterprise1 meets the power criterion with respect to VIE. Enterprise1 is a wholly owned subsidiary of Parent. In exchange for directing activities, Enterprise1 is paid a fee that is below market and therefore is a variable interest in VIE. Enterprise1's economic interests in VIE are disproportionately small relative to its power and do not meet the significant variable interest criterion (see section 6.6).

Enterprise2, another wholly owned subsidiary of Parent, holds the remaining economic interest in VIE, but does not meet the power criterion.



Evaluation

The tie-breaker test is used to determine which subsidiary is most closely associated with VIE (see Question 6.5.240). This includes consideration of all relevant facts and circumstances, including (but not limited to) those discussed in Questions 6.5.260 through 6.5.300. That subsidiary would be required to consolidate VIE. It is not appropriate to conclude that Parent should directly consolidate VIE in lieu of either subsidiary, unless Parent:

— also holds a variable interest in VIE; and
— is deemed to be most closely associated with VIE based on the tie-breaker test.

Even if Enterprise1's economic interest was significant enough to meet the significant variable interest criterion (see section 6.6), it is appropriate to evaluate the substance of the arrangements because the parties in the related party group are under common control.

If the tie-breaker test indicates that Enterprise2 is most closely associated with VIE, the separation of power and economics between Enterprise1 and Enterprise2 (i.e. the enterprises under common control) may be non-substantive. As such, even though Enterprise1 may appear to meet the primary beneficiary criteria, it may be appropriate to conclude that Enterprise2 is the primary beneficiary of VIE.

Question 6.5.330

How is the related party guidance applied to an affordable housing tax credit structure?

Interpretive response: Investors that qualify to apply the guidance for investments in qualified affordable housing projects are not required to apply the related party guidance in the VIE consolidation guidance. Subtopic 323-740 allows investors to use the proportional amortization method to account for investments in qualified affordable housing projects if specified conditions are met.

Without the exception, the revised related party guidance may have required an LP to consolidate the affordable housing tax credit partnership in the same circumstances. The FASB decided that the revised related party guidance should not override the guidance in Subtopic 323-740. [323-740-25-1]

See KPMG Handbook, Accounting for income taxes, Appendix B for additional guidance on applying the proportional amortization method.

6.6 Significant variable interest criterion

6.6.10 Overview

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

25-38A A reporting entity with a variable interest in a VIE shall assess whether the reporting entity has a controlling financial interest in the VIE and, thus, is the VIE's primary beneficiary. This shall include an assessment of the characteristics of the reporting entity's variable interest(s) and other involvements (including involvement of related parties and de facto agents), if any, in the VIE, as well as the involvement of other variable interest holders. Paragraph 810-10-25-43 provides guidance on related parties and de facto agents. Additionally, the assessment shall consider the VIE's purpose and design, including the risks that the VIE was designed to create and pass through to its variable interest holders. A reporting entity shall be deemed to have a controlling financial interest in a VIE if it has both of the following characteristics:…

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.

…

The second primary beneficiary criterion is the significant variable interest criterion. To meet this criterion, an enterprise must have the obligation to absorb losses or right to receive benefits that could potentially be significant to a VIE. An enterprise should consider both current and potential future circumstances when evaluating this criterion. Further, a quantitative approach should not be the sole determinant in evaluating this criterion. [810-10-25-38A(b)]

Question 6.6.10

Do variable interests that convey the power criterion typically meet the significant variable interest criterion?

Interpretive response: Presumptively yes. In most situations, a variable interest holder that meets the power criterion also meets the significant variable interest criterion. The level of an enterprise's economic interest often indicates the amount of power that enterprise holds (see section 6.6.30). An enterprise would not typically be vested with the power to direct the activities that most significantly impact the economic performance of a VIE without also having more than an insignificant economic interest in the VIE.

However, the FASB did not establish bright lines for determining whether obligations or rights could potentially be significant to a VIE. Therefore, it is possible for an enterprise with an insignificant economic interest in a VIE to meet the power criterion via an agency relationship with other variable interest holders when specific conditions are met; see sections 3.8.10 and 3.8.20 for guidance on decision-maker fees. This situation can also occur when a related party relationship exists among the variable interest holders (see section 6.5.30). [810-10-25-38A(b)]

Question 6.6.20

Are losses of the entity and benefits from the entity limited to profits or losses?

Interpretive response: No. The terms 'losses of the entity' and 'benefits from the entity' are not limited to US GAAP profits or losses. This concept is illustrated in Case G in section 6.8 (paragraphs 810-10-55-172 to 55-181).

Case G implies that the economic utility of a leased asset enjoyed by the lessee during the lease term should be considered in the analysis of which party meets the power criterion. The lessor entity does not recognize US GAAP profits or losses from the performance of the leased asset during the lease term. Even though the lessee is not entitled to any of the lessor's US GAAP income from the lease, the lessee's variable interest is still viewed as conveying benefits from the lessor.

Similarly, an enterprise may receive advertising services from a VIE and reimburse the VIE for the cost of those services. The VIE derives no net income as a result of the arrangement. However, we believe this benefit should be considered as part of the criterion evaluation.

Question 6.6.30

How is 'significant to the VIE' defined when considering absorbing losses or receiving benefits?

Interpretive response: The FASB did not provide additional guidance on whether an enterprise's obligation to absorb losses or its right to receive benefits could potentially be significant to the VIE. This was to avoid creating bright lines that would be used as rules in practice. The FASB instead emphasized that all facts and circumstances should be considered, including the VIE's purpose, design and characteristics and the enterprise's other involvement with the VIE.

Factors to consider when evaluating whether an enterprise's obligation to absorb losses or right to receive benefits could potentially be significant to the VIE include: [810-10-25-38A(b)]

- the purpose, design, and structure of the VIE, including the terms of the VIE's variable interests and nature of its variability;
- whether any of the enterprise's or VIE's exposure to losses or benefits is capped;
- the nature of the VIE's capital structure, including where in the structure the enterprise's interest resides;
- the magnitude of the VIE's variable interests held by the enterprise; and
- the rationale for the enterprise holding a variable interest in the VIE. For example, holding an interest for reputational reasons may indicate that the enterprise is exposed to losses or benefits that may be significant to the VIE.

For guidance on evaluating a VIE's purpose and design when applying the by-design approach for identifying variable interests, see section 3.3.

When evaluating the significant variable interest criterion, we believe it may be reasonable to use a threshold of 10%, as discussed in Question 6.6.140. When computing an enterprise's variable interest, we believe it includes its direct interest in the VIE and the direct interests held by its consolidated subsidiaries (even if those consolidated subsidiaries are not wholly owned).

Question 6.6.40

When evaluating 'significant to the VIE', is a quantitative approach required?

Interpretive response: No, but quantitative information may be relevant. The SEC staff (see speech excerpt below) and FASB believe that determining whether a party's rights or obligations are significant to a VIE is best resolved through a qualitative framework. Quantitative analyses of expected losses and residual returns are often less precise and effective in assessing the significance of risks and rewards than qualitative analyses. Therefore, the analysis generally should be qualitative. [FAS 167.A43, 2010 AICPA Conf]

Although a quantitative analysis is not required, readily apparent quantitative information cannot be ignored in a qualitative analysis. Therefore, when a variable interest is quantitatively significant, we believe an enterprise must consider such quantitative information when evaluating the significant variable interest criterion.

An enterprise should also consider information that indicates a variable interest is quantitatively insignificant. In that case, future events or scenarios may cause the enterprise's exposure to variability to increase. Therefore, an enterprise may conclude that a quantitatively insignificant variable interest is significant based on qualitative factors.

Excerpt from SEC staff speech

We understand that some would prefer to determine whether their rights or obligations could potentially be significant to the variable interest entity based solely on a quantitative approach. However, the model doesn't accommodate that because the model is based on making a determination that must incorporate and weigh the context of the entity's purpose and design. So, questions about whether a party's rights or obligations are significant to the entity are best resolved through a qualitative framework that weighs the particular facts and circumstances of the party's rights and obligations.

Contrary to popular belief, the staff has not developed bright lines that a registrant has to satisfy when applying this aspect of the standard. It would not promote the objectives of the standard to do so.

I understand that this evaluation can be challenging in some arrangements. For example, we have heard about challenges in evaluating whether fee arrangement for a decision maker could potentially be significant, particularly

> where some portion of the fee is senior to most or all of the entity's other obligations and the remaining portion is subordinated. I would encourage registrants to consider all the facts and circumstances when making this determination...
>
> *Paul A. Beswick, Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments*

Question 6.6.50
Is likelihood considered when evaluating the significant variable interest criterion?

Interpretive response: No. In evaluating the criterion, enterprises do not consider likelihood of future losses or benefits. Absorbing losses or receiving benefits that are potentially significant to the VIE should include an evaluation all possibilities. Potentially significant obligations or rights often identify the enterprise that explicitly or implicitly meets the power criterion. Therefore, given this connection between the two primary beneficiary criteria, it is important to consider all possible outcomes.

In contrast, likelihood is important when evaluating whether a fee is a variable interest. In that case, an enterprise considers the probability of occurrence of events in determining whether its other interests in the entity would absorb more than an insignificant amount of the VIE's expected losses or expected residual returns (see section 3.8.10).

Question 6.6.60
What factors are considered when determining whether a variable interest could potentially be significant to a VIE?

Interpretive response: Determining whether a variable interest could potentially be significant requires judgment and consideration of all facts and circumstances, including:

- the purpose and design of the entity, including the risks the entity is designed to create and pass on to its variable interest holders (see section 3.3); and
- the terms and characteristics of the enterprise's variable interest.

The SEC staff has discussed factors that should be considered when determining whether a variable interest could potentially be significant to a VIE (see excerpt below). [2009 AICPA Conf]

The staff comments include a statement that a financial interest's level of seniority may be an important factor. Because the significance analysis is not probability-based, we believe the staff's reference to seniority was directed at the need to understand:

— what losses the interest could be obligated to absorb; and
— what benefits the interest could be entitled to receive.

The characteristics of the financial interest can impact the losses absorbed and benefits received, which is why it is important to consider seniority. A residual interest (or other interest with an equity-like return) presumptively would be potentially significant because it conveys the right to receive benefits that could be significant to the entity. Conversely, a senior interest in a VIE with a debt-like return may lack the right to receive benefits that could be significant to the VIE. However, if the senior interest is significant relative to the VIE, it has the obligation to absorb losses that could be significant to the VIE.

Business purpose for holding the financial interest

We understand that the SEC staff intended the third factor (business purpose for holding the financial interest) to be relevant when evaluating fees paid to decision-makers.

When evaluating whether the enterprise is acting solely as a fiduciary (see section 3.8.10), the business circumstances that led to the enterprise holding the financial interest may be relevant. Therefore, this factor should be considered when analyzing the significance of fees paid to decision-makers, instead of when analyzing the significant variable interest criterion. That is, it might be a factor to consider when the power to direct the most significant activities is conveyed through a service contract instead of through a non-fee variable interest. The enterprise's business purpose for holding the financial interest should not affect the evaluation of the significant variable interest criterion.

See Question 3.8.100 for guidance on evaluating fees paid to a decision-maker and the 'more than insignificant' notion.

Excerpt from SEC staff speech

ASU 2009-17 describes [a significant financial] interest as one that either obligates the reporting enterprise to absorb losses of the entity or provides a right to receive benefits from the entity that could potentially be significant. That description leaves us with an important judgment to make regarding what could potentially be significant.

Similar to how we have talked in the recent past about materiality assessments being based on the total mix of information, we believe that assessing significance should also be based on both quantitative and qualitative factors. While not all-inclusive, some of the qualitative factors that you might consider when determining whether a reporting enterprise has a controlling financial interest include:

The purpose and design of the entity. What risks was the entity designed to create and pass on to its variable interest holders?

A second factor may be the terms and characteristics of your financial interest. While the probability of certain events occurring would generally not factor into an analysis of whether a financial interest could potentially be significant, the terms and characteristics of the financial interest (including the level of seniority of the interest), would be a factor to consider.

A third factor might be the enterprise's business purpose for holding the financial interest. For example, a trading-desk employee might purchase a financial interest in a structure solely for short term trading purposes well after the date on which the enterprise first became involved with the structure. In this instance, the decision making associated with managing the structure is independent of the short-term investment decision. This seems different from an example in which a sponsor transfers financial assets into a structure, sells off various tranches, but retains a residual interest in the structure.

As previously mentioned this list of qualitative factors is neither all-inclusive nor determinative and the analysis for a particular set of facts and circumstances still requires reasonable judgment.

Arie S. Wilgenburg, Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB Developments

Question 6.6.70

Can a variable interest that is expected to absorb only insignificant variability of a VIE meet the significant variable interest criterion?

Interpretive response: Yes. An enterprise must consider all possible scenarios when evaluating whether its variable interest conveys the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. This is regardless of probability of occurrence.

If, under any circumstances, it is possible that a variable interest would absorb losses or receive benefits that could be significant to the VIE (relative to total losses or total benefits in that given scenario), the variable interest would meet the criterion. Probability of expected outcomes relative to a particular interest are not relevant to the analysis of the significant variable interest criterion. See also Question 6.6.50.

Example 6.6.10

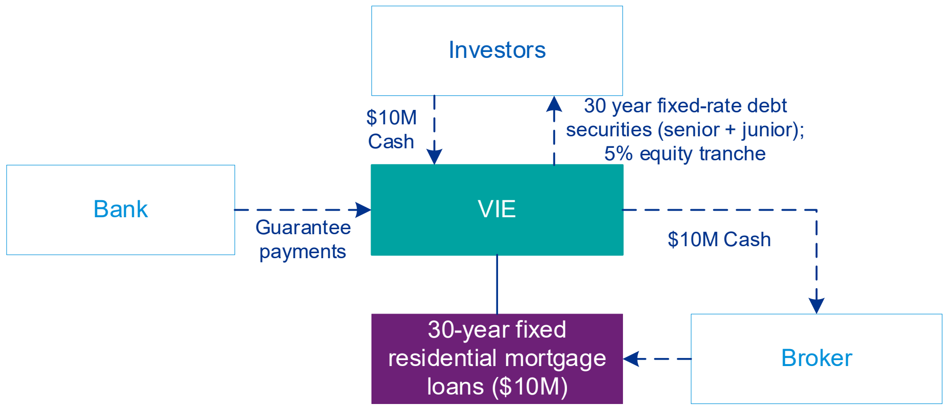
Considering all potential scenarios

Background

VIE is created and financed with the issuance of two tranches (senior and mezzanine) of 30-year fixed-rate debt securities and the issuance of an equity tranche for total capital of $10 million. The equity tranche represents 5% of VIE's total capital.

VIE uses the proceeds to purchase $10 million of 30-year fixed-rate residential mortgage loans from Broker and enters into a guarantee facility with Bank.

Under the guarantee, Bank is obligated to make payments only after the credit losses on VIE's assets (30-year fixed-rate residential mortgage loans) exceed the amount of its equity tranche.



Evaluation

Variable interest holders must evaluate all potential scenarios that may occur during their involvement with a VIE when evaluating whether they meet the significant variable interest criterion. The equity tranche represents only 5% of VIE's total capital. If the guarantee is triggered, the amount of losses that would be absorbed by Bank could be significant to VIE. Therefore, even if it is unlikely that Bank would be obligated to make payments under the guarantee arrangement, Bank meets the criterion.

Question 6.6.80

Are interests held by related parties considered when assessing when an enterprise meets the significant variable interest criterion?

Interpretive response: It depends. An enterprise that is a single decision-maker includes its direct economic interests (including the direct interests of its consolidated subsidiaries; see Question 6.6.30) and indirect interests held through related parties (including de facto agents) in determining whether it individually meets the significant variable interest criterion (see Question 6.6.90).

When a single decision-maker whose fee is a variable interest does not individually meet the significant variable interest criterion, further analysis of related party interests is required to determine the applicability of the related party tie-breaker test (see Question 6.5.240). If members of the single decision-maker's common control related party group also have variable interests, the tie-breaker test is required if that group collectively meets the significant variable interest criterion.

When determining whether the common control group meets the significant variable interest criterion, we believe the group's interests generally include:

- the direct interests in the VIE held by the members of the common control group (see Question 3.8.230); and
- the indirect interests in the VIE held by the members of the common control group, but only if the holder of the direct interest is also in the common control group.

Question 3.8.230 provides guidance on identifying a common control group.

In some situations, we believe the common control group should include other parties' interests. For example, if the ownership interests have been structured to avoid consolidation by the decision-maker – i.e. by separating the power from the potentially significant variable interest. The determination of whether a related party under common control is being used to separate power from economics to avoid consolidation by the decision-maker will often require significant judgment based on the specific facts and circumstances (see Question 3.8.200).

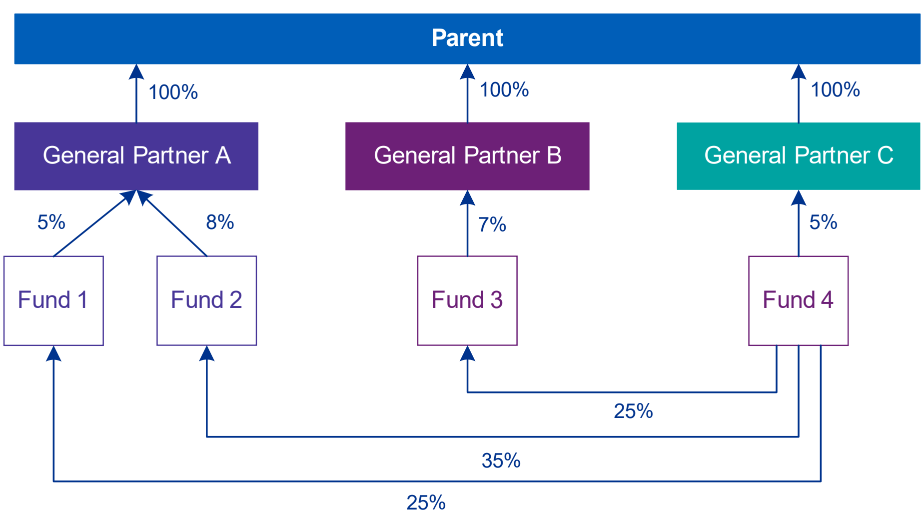
The effects of related parties and de facto agency relationships for enterprises that are not a single decision-maker is discussed in section 6.5.30.

Example 6.6.20
Indirect interests excluded

Background

General Partner C (GP-C) is evaluating whether to consolidate Fund 4. Fund 4 is a VIE and GP-C does not individually meet both criteria to be the primary beneficiary of Fund 4.

The ownership structure relevant to the parties is as follows.



GP-A, GP-B and GP-C are related parties under the common control of Parent. Funds 1, 2, and 3 are not under common control with GP-C because they are not consolidated by GP-A or GP-B.

Evaluation

GP-C does not include GP-A's indirect interest of 4.1% ((8% × 35%) + (5% × 25%)) or GP-B's indirec.t interest of 1.8% (7% × 25%) in Fund 4 when evaluating whether the common control group collectively meets the significant variable interest criterion. This is because Funds 1, 2 and 3 are not under common control with GP-C.

Therefore, GP-C is not required to apply the tie-breaker test to determine which party in the related party group is most closely associated with and required to consolidate Fund 4. GP-C's direct variable interest of 5% alone is not potentially significant.

Note: When Parent evaluates whether it has a potentially significant variable interest in Fund 4, it considers the interests held by its consolidated subsidiaries as if they were its own. As a result, Parent's total interest in Fund 4 includes the 5% direct interest held by GP-C and the indirect interests held by GP-A (4.1%, through its investments in Funds 1 and 2) and GP-B (1.8%, through its investment in Fund 3). This is because Parent has a controlling financial interest in all three GPs. Therefore, Parent is required to consolidate Fund 4 because it meets both primary beneficiary criteria.

The calculation of Parent's variable interest would not change if it owned less than 100% of the GP subsidiaries.

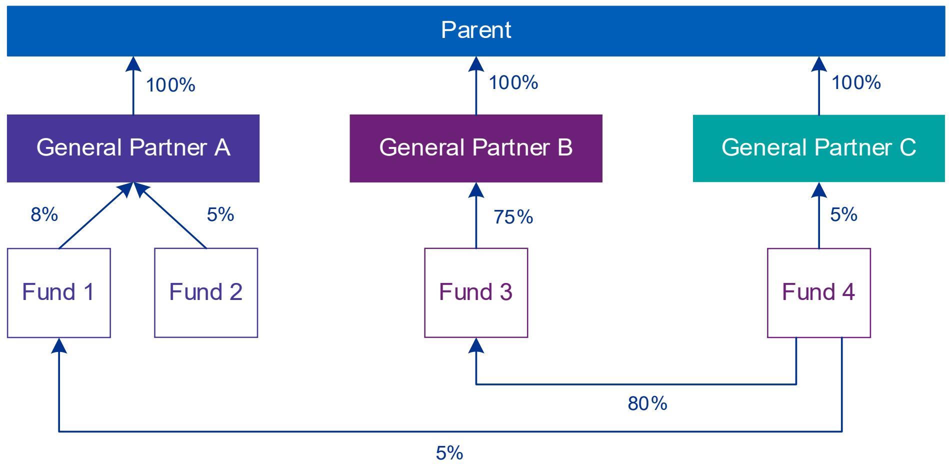
Example 6.6.30
Indirect interests included

Background

General Partner C (GP-C) is evaluating whether to consolidate Fund 4.

Modifying the facts in Example 6.6.20, the purpose and design of Fund 3 is to invest in Fund 4, and it has an 80% interest in Fund 4. Further:

— GP-B holds a 75% interest in Fund 3 but does not have a controlling financial interest in the fund.
— Fund 1 holds a 5% interest in Fund 4.
— Fund 2 holds no interest in Fund 4.



Evaluation

GP-C does not include GP-A's indirect interest of 0.4% (8% × 5%) because Fund 1 is not under common control with GP-C.

However, we believe GP-C should include GP-B's indirect interest of 60% (75% × 80%) in Fund 4 when evaluating whether the common control group collectively meets the significant variable interest criterion. This is because Fund 3 was designed to invest in Fund 4 – i.e. its interest is substantively a direct interest in Fund 4 by GP-B.

The common control group that includes GP-B and GP-C collectively meets the significant variable interest criterion and one of the GPs is required to consolidate Fund 4 using the tie-breaker test (see Question 6.5.240).

6.6.20 Single decision-makers

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

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.

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

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

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

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

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

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

>> The Effect of Related Parties

25-42 Single Decision Maker—The assessment in this paragraph shall be applied only by a single reporting entity that meets the characteristic in paragraph 810-10-25-38A(a). For purposes of determining whether that single reporting entity, which is a single decision maker, is the primary beneficiary of a VIE, the single decision maker shall include all of its direct variable interests in the entity and, on a proportionate basis, its indirect variable interests in the entity held through related parties (the term *related parties* in this paragraph refers to all parties as defined in paragraph 810-10-25-43). For example, if the single decision maker owns a 20 percent interest in a related party and that related party owns a 40 percent interest in the entity being evaluated, the single decision maker's indirect interest in the VIE held through the related party would be equivalent to an 8 percent direct interest in the VIE for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b) (assuming it has no other relationships with the entity). Similarly, if an employee (or de facto agent) of the single decision maker owns an interest in the entity being evaluated and that employee's (or de facto agent's) interest has been financed by the single decision maker, the single decision maker would include that financing as its indirect interest in the evaluation. For example, if a single decision maker's employees have a 30 percent interest in the VIE and one third of that interest was financed by the single decision maker, then the single decision maker's indirect interest in the VIE through the financing would be equivalent to a 10 percent direct interest in the VIE.

An enterprise is a single decision-maker if it individually has the power to direct the activities that most significantly impact a VIE's economic performance. However, it is not the primary beneficiary unless its fee is a variable interest in the VIE (see section 3.8) and:

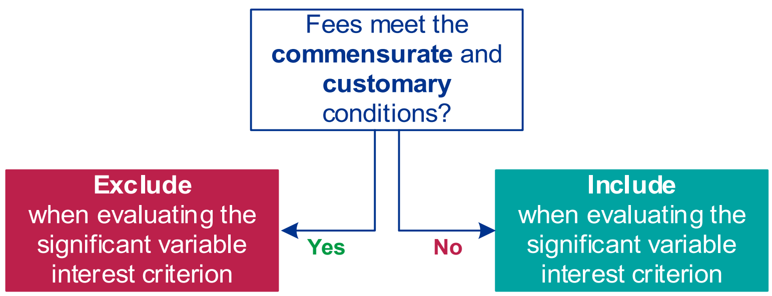
— it meets the significant variable interest criterion (see section 6.6); or

— its common control group meets the significant variable interest criterion and the single decision-maker is most closely associated with the VIE (see section 6.5.30).

When evaluating the significant variable interest criterion, a single decision-maker is required to consider both its: [810-10-25-42]

— direct variable interests; and
— indirect variable interests held through related parties and de facto agents (see section 6.5.20).

However, fees paid to a decision-maker or service provider are excluded from the evaluation of the significant variable interest criterion if they meet both the commensurate and the customary conditions. [810-10-25-38H]



Question 6.6.90

How does a single decision-maker determine whether it meets the significant variable interest criterion?

Interpretive response: When evaluating the significant variable interest criterion, a single decision-maker considers both its: [810-10-25-42]

— direct variable interests; and
— indirect variable interests held through related parties and de facto agents.

Direct variable interests exclude fees that are both commensurate and customary for the single decision-maker's services (see Question 6.6.100). However, fees or payments that expose the service provider to a risk of loss are included as direct variable interests (see Question 6.6.120). [810-10-25-38H – 25-38J]

Indirect variable interests held through related parties include the single decision-maker's proportionate share of the variable interest based on (1) its interest in the related party and (2) the related party's interest in the VIE, regardless of whether the decision-maker and the related party that holds the interest in the VIE are under common control.

If the single decision-maker holds no direct interest in a related party, it generally does not include any of the related party's variable interest when evaluating the significant variable interest criterion.

However, if a decision-maker finances a portion of an employee's or a de facto agent's interest in a VIE, it includes its proportionate economic interest in the VIE. For example, if an employee of the decision-maker holds a 40% equity investment in a VIE and the decision-maker financed half of that investment, the decision-maker's indirect interest in the VIE is 20%. [810-10-25-42]

Section 3.8.20 provides additional guidance on a decision-maker's computation of indirect interests held through related parties.

Typically, a single decision-maker whose fee is a variable interest will also meet the significant variable interest criterion (see Question 6.6.150).

If its fee is not a variable interest in the VIE, a single decision-maker cannot be the primary beneficiary (see Question 6.2.80). However, if the single decision-maker has an insignificant other variable interest (e.g. an equity interest), it considers the VIE disclosure requirements related to that other variable interest (see Question 3.125). See chapter 8 for applicable disclosure requirements.

Question 6.6.100

How are the commensurate and customary conditions evaluated?

Interpretive response: When evaluating the commensurate and customary conditions, an enterprise considers whether the design of the arrangement is consistent with the enterprise's role or the type of service. Similar arrangements among parties outside of the relationship being evaluated may be helpful in analyzing the conditions. However, similar arrangements may not exist when the service is new or unique, or when there is a change in what is considered customary. [810-10-25-38H – 25-38I]

Section 3.8.10 provides additional guidance on evaluating whether a decision-maker fee is commensurate and customary. Although that guidance is provided in the context of evaluating whether the fee is a variable interest, the analysis is the same. [810-10-55-37 – 55-37B]

If an arrangement exposes the decision-maker to risk of loss in the VIE, the commensurate and customary conditions do not apply (see Question 6.6.120). Therefore, such fees are included when evaluating the significant variable interest criterion. [810-10-25-38J]

The following table outlines factors to consider when determining whether a decision-maker fee meets the commensurate and customary conditions.

Do the fees meet the **commensurate** and **customary** conditions?	Consider...
	Design of the arrangement
	Enterprise's role
	Type of service
	Similar arrangements
	Risk of loss

Question 6.6.110

Why are certain fees excluded when evaluating the significant variable interest criterion?

Interpretive response: Fees that meet the commensurate and customary conditions are excluded from the evaluation of the significant variable interest criterion. This is irrespective of whether: [810-10-25-38H]

- the fees are subject to lock-up provisions;
- the fees are settled in variable interests (i.e. not cash) of the VIE; or
- other variable interests are held by the decision-maker or service provider.

Topic 810 places more emphasis on variable interests other than fee arrangements. This is because these fee arrangements do not subject the decision-maker to a risk of loss, unlike capital investments or guarantees. The risk associated with compensation exposes a decision-maker to opportunity costs of the nonreceipt of fees, not to losses of the VIE. Therefore, a fee that meets the commensurate and customary conditions reflects an agency or fiduciary role and is excluded from the analysis.

Section 3.8.10 provides additional guidance on evaluating whether a decision-maker fee is commensurate and customary. Although that guidance is provided in the context of evaluating whether the fee is a variable interest, the analysis is the same. [810-10-55-37 – 55-37B]

Question 6.6.120

What fees are included by the decision-maker in evaluating whether it meets the significant variable interest criterion?

Interpretive response: An arrangement may expose the decision-maker to risk of loss in the VIE. Fees or payments in connection with such an arrangement should be included in the evaluation of the significant variable interest criterion.

Examples include: [810-10-25-38J]

- guarantees of the legal entity's assets or liabilities;
- obligations to fund operating losses;
- written put options on the entity's assets;

— liquidity commitments; and
— other explicit or implicit agreements that protect other interest holders from absorbing the entity's losses.

As a result, if an arrangement is structured as a means to absorb risk of loss in exchange for a fee, the related fees are included in evaluating the significant variable interest criterion. Section 3.8.10 provides additional guidance on evaluating which fees expose a decision-maker to loss. Although that guidance is provided in the context of evaluating whether the fee is a variable interest, the analysis is the same.

Question 6.6.130

Can an enterprise be a single decision-maker if it doesn't earn a fee?

Interpretive response: Yes. An enterprise that has decision-making rights conveyed through a variable interest other than a fee-based arrangement can be a single decision-maker and is required to evaluate whether its variable interest causes it to be the VIE's primary beneficiary.

For example, in a lending arrangement, the lender may receive rights to make decisions about the activities that most significantly impact the borrower's economic performance in an event of default. Even though the lender is not being paid a fee under this arrangement, it is still acting in the capacity of a single decision-maker in the case of default. Therefore, the lender is required to evaluate whether it is the borrower's primary beneficiary under the primary beneficiary criteria (see Question 6.3.160).

Question 6.6.140

Is the threshold for evaluating the significant variable interest criterion the same as the threshold for evaluating 'more than insignificant'?

Interpretive response: Yes. While the significant variable interest criterion in the primary beneficiary analysis and the 'more than insignificant' notion in the decision-maker variable interest analysis (see section 3.8) operate differently, the threshold of significance for each is the same.

Topic 810 provides no quantitative threshold. We believe it may be reasonable to use a threshold of 10%, as follows.

Significant variable interest criterion	'More than insignificant' notion
The evaluation of the significant variable interest criterion considers all possible outcomes (regardless of probability).	When assessing the significance of other interests, an enterprise considers the VIE's expected (probability-weighted) outcomes.

Significant variable interest criterion	'More than insignificant' notion
An enterprise does not have a potentially significant variable interest if it does not have an interest that could potentially absorb > 10% of the VIE's losses or could potentially receive > 10% of the VIE's benefits.	A decision-maker fee is not a variable interest if other interests do not absorb > 10% of the VIE's total expected variability.

See Question 3.8.100 for discussion of the 'more than insignificant' notion.

Question 6.6.150

Is a decision-maker fee that is a variable interest typically also potentially significant?

Interpretive response: Yes. When a decision-maker's fee is a variable interest, it usually also meets the significant variable interest criterion.

If…	A decision-maker fee is a variable interest because it does not meet the commensurate and customary conditions (section 3.8.10)
Then…	it usually meets the significant variable interest criterion because the related variability is usually potentially significant to the VIE. Alternatively, if the fee meets the commensurate and customary conditions, its related variability is not considered when evaluating the significant variable interest criterion.

If…	A decision-maker fee is a variable interest because in aggregate, other variable interests held by the decision-maker (and its indirect interests held through its related parties), absorb more than an insignificant amount of the VIE's variability (section 3.8.20)
Then…	it usually meets the significant variable interest criterion because those other variable interests will also be potentially significant.

As a result, if a decision-maker fee is a variable interest, the decision-maker is usually the primary beneficiary because it meets both primary beneficiary criteria. Examples 3.8.10 and 3.8.20 illustrate this guidance.

Example 6.6.40

Indirect interests in a VIE held through related parties and de facto agents of a single decision-maker

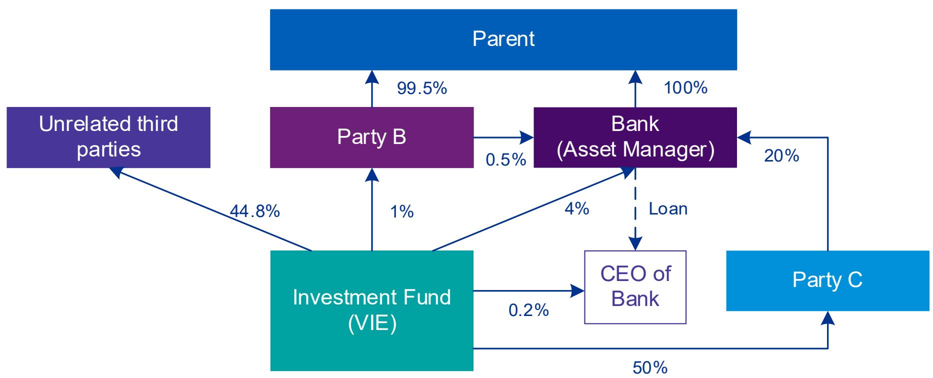
Background

VIE is created to hold a portfolio of asset-backed securities and is financed with multiple classes of debt and nominal equity. Bank is the asset manager of VIE and for its services earns base, fixed-senior and subordinated fees and a performance-based fee in which it receives a portion of VIE's profits above a targeted return. The fees are considered commensurate with the services provided and only include customary terms and conditions.

Bank has the power to direct the activities that most significantly impact VIE's economic performance. VIE's other variable interest holders lack the right to remove Bank as the asset manager without cause and lack any other rights to participate in the decisions about VIE's activities.

Bank holds 4% of each class of VIE's debt and equity. Party B (which is under common control with Bank) holds a 1% interest in each class of VIE's debt and equity.

Bank owns 0.5% of Party B's equity. Bank's CEO holds 0.2% of each class of VIE's debt and equity. Bank provided a loan to its CEO for half of the CEO's investment. Party C holds a 50% interest in each class of the VIE's debt and equity. Bank owns 20% of Party C's equity and therefore they are related parties.



Scenario 1 evaluation: Bank has interests in Parties B and C

Bank has the power to direct the activities that most significantly impact VIE's economic performance. As a result, it must determine whether its fee arrangement is a variable interest and if so whether it meets the significant variable interest criterion.

To make these determinations, Bank includes the following interests:

— its 4% direct interest in VIE;
— 0.5% of Party B's 1% interest in VIE;
— 50% of its CEO's 0.2% interest; and
— 20% of Party C's 50% interest.

Bank's fees are considered a variable interest (see Question 3.8.100) and it meets the significant variable interest criterion because its direct and indirect interests (excluding its fee) total over 14%. Bank is VIE's primary beneficiary.

There is no additional consideration of related parties because Bank individually meets both primary beneficiary criteria.

Scenario 2 evaluation: Bank has no interest in Party B

Assume the same facts as above, except that Bank does not own any of Party B's equity.

In this scenario, Bank excludes Party B's interest from its evaluation of whether it has a variable interest and meets the significant variable interest criterion.

However, the conclusion that Bank is the primary beneficiary does not change because Bank still has a variable interest (its direct and indirect interests (excluding its fee) total over 14%) and meets the significant variable interest criterion through its direct economic interest and other indirect economic interests.

Scenario 3 evaluation: Bank has no interests in Parties B or C

Assume the same facts as alternative scenario 1, except that Bank also does not own any of Party C's equity.

In this scenario, Bank's fees are not a variable interest and it also does not meet the significant variable interest criterion. The tie-breaker test is not applied because the decision-maker fee is not a variable interest. Therefore, Bank is not VIE's primary beneficiary. Further, it is unlikely that VIE has a primary beneficiary because it does not appear that substantially all of VIE's activities involve or are conducted on behalf of any one of the other parties. See Question 6.5.180 for relevant decision tree.

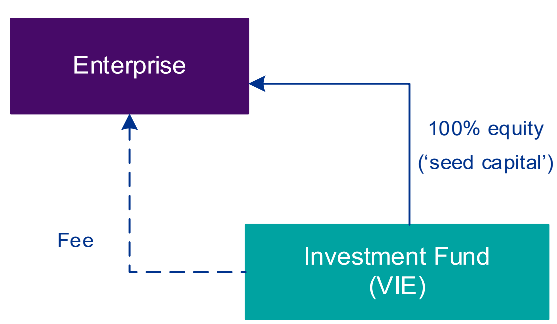
Example 6.6.50
Investment manager holds seed capital

Background

At its inception, Enterprise is the manager of Investment Fund and receives a market-based fee that meets the commensurate and customary conditions (see section 3.8.10).

Enterprise also holds 100% of the seed capital of Investment Fund. The design of Investment Fund is to obtain third-party investors and reduce Enterprise's equity interest to 5% over a three-year period.

As investment manager, Enterprise meets the power criterion. Potential investors will not have substantive kick-out rights or substantive participating rights. Therefore, Investment Fund is a VIE.

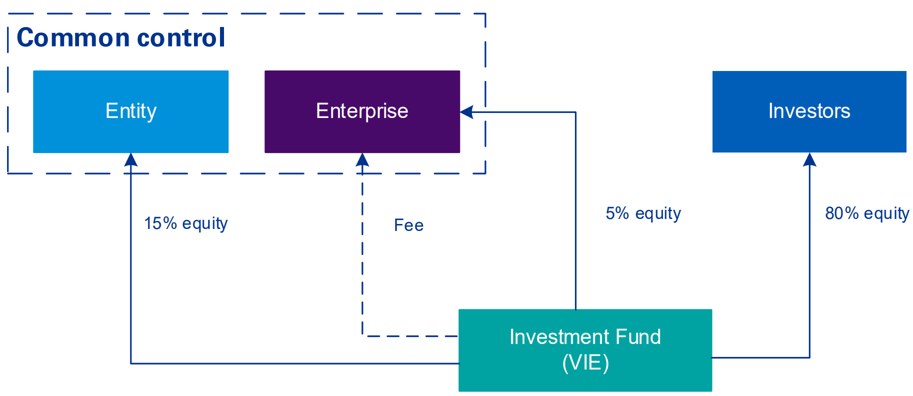


Evaluation: At inception

Variable interest determination	Primary beneficiary analysis
Enterprise's fee is a variable interest. The 100% equity interest absorbs more than an insignificant amount of Investment Fund's expected losses and receives more than an insignificant amount of Investment Fund's expected residual returns. Therefore, the insignificant condition is not met (see section 3.8.10).	**Enterprise is Investment Fund's primary beneficiary.** Enterprise meets both the power criterion and the significant variable interest criterion.

Evaluation: Three years later

Three years after Investment Fund's inception, various third parties acquire 80% of Investment Fund's equity interests and Entity acquires 15% of Investment Fund's equity interests. Entity is a related party under common control with Enterprise (i.e. Entity is an affiliate). Enterprise does not hold an interest in Entity.



Variable interest determination	Primary beneficiary analysis
Enterprise's fee is not a variable interest. Because Enterprise does not hold an interest in Entity, the interest held by Entity is excluded from the evaluation of whether Enterprise's fee is a variable interest. As a result, Enterprise's direct and indirect interests (5%) do not absorb more than an insignificant amount of Investment Fund's expected losses or receive more than an insignificant amount of its expected residual returns. Therefore, the insignificant condition is met (see Question 3.8.210). However, an exception applies if the investment by Entity is made to separate power from economics so that Enterprise can avoid consolidation of Investment	**It depends on whether Enterprise's fee is a variable interest.** If Enterprise's fee meets the insignificant condition (i.e. its fee is not a variable interest), it is not the primary beneficiary. Enterprise is acting solely in a fiduciary manner, and it does not meet the significant variable interest criterion. Although Enterprise is the single decision-maker, once it is determined that its fee is not a variable interest, it can conclude that it is not the primary beneficiary (see Question 6.2.80). However, if Enterprise's fee does not meet the insignificant condition (i.e. its fee is a variable interest) because Entity's investment is included in the analysis of Enterprise's direct and indirect interests,

Variable interest determination	Primary beneficiary analysis
Fund (see Question 3.8.200). In that case, Entity's investment would be included in the analysis of Enterprise's direct and indirect interests, resulting in a total interest of 20%. As a result, Enterprise's fee would be a variable interest, because it would not meet the insignificant condition.	Enterprise would also need to include Entity's interest in its analysis of the significant variable interest criterion. As a result, Enterprise would meet both of the primary beneficiary criteria and consolidate Investment Fund.

6.6.30 Economic interest vs stated power

Excerpt from ASC 810-10

Variable Interest Entities

> Consolidation Based on Variable Interests

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.

Disproportionality between an enterprise's stated power and its economic interest in a VIE should be considered when assessing the power criterion. If an enterprise has a disproportionate share of economic interests compared to its stated power, an enterprise's economic interest may be indicative of the power the enterprise has over the VIE. As a result, actual power may extend beyond the stated power. [810-10-25-38G]

Question 6.6.160

If disproportionality exists, what should be considered?

Interpretive response: In situations where disproportionality exists, enterprises should carefully evaluate whether:

- the activities that most significantly impact the VIE's economic performance have been appropriately identified; and
- all arrangements or other interests that convey power have been appropriately analyzed.

As discussed in Question 6.2.70, all sources of power should be considered and carefully evaluated.

Question 6.6.170

Is disproportionality more likely when a decision-maker's fee is not a variable interest?

Interpretive response: Yes. When a decision-maker's fee is not a variable interest, it may be necessary to evaluate whether the decision-maker's stated or contractual decision-making rights substantively belong to another variable interest holder. The SEC staff has commented on these situations (see below). [2014 AICPA Conf]

Excerpt from SEC staff speech

Another topic recently considered by the staff is how to evaluate power when a decision maker is acting in an agency capacity. Said differently, does the VIE consolidation analysis stop if a reporting entity determines that a fee paid to a decision maker by a VIE is not a variable interest?[1] For purposes of illustration, assume an entity forms an SPE to securitize loans. The design and purpose of the SPE is to finance the entity's loan origination activities. The entity provides the investors in the SPE with a guarantee protecting against all credit losses. The SPE hires a third party to service the loans and to perform default mitigation activities. Assume the servicer cannot be removed without the consent of investors and its fee is not a variable interest.[2]

In thinking through this example, the staff believes that in certain cases it may be necessary to continue the consolidation analysis when it is determined that a fee paid to a decision maker is not a variable interest and further consider whether the substance of the arrangement identifies a party other than the decision maker as the party with power. While this can require a great deal of judgment, additional scrutiny may be necessary if a decision maker is acting as an agent and one variable interest holder is absorbing all or essentially all of the variability that the VIE is designed to create and pass along. In these situations, stated power may not be substantive, and it may be appropriate to attribute the stated power of the decision maker acting as an agent to the variable interest holder absorbing the variability of the VIE. It is helpful to keep in mind that the level of a reporting entity's economic interest in a VIE may be indicative of the amount of power that the reporting entity holds.[3] While the VIE guidance states that this factor is not determinative in identifying the primary beneficiary, the staff does believe that the level of a reporting entity's economics is an important consideration in the analysis and may be telling of whether stated power is substantive.

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1 Paragraph A76 of the Basis for Conclusions to Statement 167 provides that a decision maker is acting in an agency capacity when the fee it receives for performing services is not a variable interest.
2 ASC 810-10-55-37.
3 810-10-25-38G.

Christopher F. Rogers, Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments

Example 6.6.60

Evaluating power when the decision-maker's fee is not a variable interest

Background

GP holds a 2% equity interest in Limited Partnership (VIE), and its decision-maker fee is embedded in its equity interest. GP's fee does not represent a variable interest (see Question 3.8.10).

One LP holds a 98% limited partnership interest. That LP lacks substantive participating rights or kick-out rights.

GP and LP are not related parties and neither holds an interest in the other.

Evaluation: GP

GP does not consolidate VIE because its decision-maker fee (which is conveyed through the equity interest) is not a variable interest. When the fee is not a variable interest, GP is deemed to be acting in a fiduciary capacity; therefore, GP does not meet the power criterion and cannot consolidate VIE (see Question 6.2.80).

Evaluation: LP

LP meets the significant variable interest criterion (see section 6.6). However, LP does not meet the power criterion. Generally, an LP should not consolidate a limited partnership that is a VIE if it does not meet this criterion, unless it is required to do so under the related party primary beneficiary requirements (see section 6.5.30).

However, as discussed in Question 6.6.170, when a decision-maker fee is not a variable interest, it may be necessary to evaluate whether the decision-maker's stated or contractual decision-making rights substantively are attributable to another variable interest holder (LP in this example).

See Example 6.5.40 for additional discussion of this fact pattern when the GP and the LP are related parties under common control.

Question 6.6.180
What is the effect when parties with shared power have economic interests that are disproportionate to their decision-making rights?

Interpretive response: Disproportionality between the decision-making rights and the economic interests of the parties with shared power may indicate that the parties' stated rights are not substantive; this is particularly the case when one of the parties is exposed to substantially all of the risks of ownership. All facts and circumstances should be considered in evaluating this type of scenario.

The SEC staff commented on these situations and noted that there may be circumstances in which a manager that purportedly has shared power is actually acting as an agent of another party that purportedly has shared power. Further, a managing member of an entity for which power is purportedly shared may meet the power criterion. See excerpt below. [2009 AICPA Conf]

See Question 6.5.50 for additional guidance. Also note that the SEC staff's views about purportedly shared power when a party is exposed to substantially all of the risks of ownership are consistent with the guidance in Question 6.3.70.

Excerpt from SEC staff speech

In the vein of encouraging the use of reasonable judgment, it is worth noting that only substantive terms should be considered when applying [the VIE guidance in ASC Subtopic 810-10]. Determining whether something is substantive or non-substantive is likewise a matter of judgment and depends on the facts and circumstances.

Keeping with the topic of considering the economic substance of a transaction, the staff has recently become aware of several proposed structures designed to achieve deconsolidation of underperforming assets, including past due loans, securities, and real estate. These assets are likely presenting business performance and prudential regulatory compliance issues. In order to address these issues, several structures have been proposed in which owners transfer the underperforming assets to a structure designed to technically comply with the consolidation literature and perhaps create the appearance of shared power among equity holders. However, the economic result leaves substantially all of the risks of ownership with the original owner rather than a more substantive sharing of the risks.

For example, assume a company has transferred assets to a structure to be managed by a third party, but the manager's equity interest in the structure is minimal and appears to be guaranteed given the management fee structure. In addition, assume the manager can be removed by the reporting enterprise if the manager's performance is unsatisfactory. The combination of the above factors indicates that the company may not have relinquished control; rather the manager may simply be acting as an agent on behalf of the reporting enterprise. We have also seen other, similar structures that include a buy-sell clause rather than a removal right, as a mechanism for dissolving the structure. However, if the manager does not have the financial ability to exercise its rights under the buy-sell provision, the substance of this provision may be a call option by the transferor. Again, this may be an indication that the manager is simply acting as an agent on behalf of the reporting enterprise.

In summary, and consistent with our report to Congress on off-balance sheet arrangements, the staff continues to believe that use of transaction structuring to achieve accounting and reporting goals that do not conform to the economic substance of the arrangements reduces transparency in financial reporting.[1]

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1 Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, June 2005

Arie S. Wilgenburg, Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB Developments

6.7 Primary beneficiary reconsideration

Excerpt from ASC 810-10

Variable Interest Entities

> Reconsideration of Initial Determination of VIE Status

35-4 A legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its **expected losses** that reduce the equity investment. The initial determination of whether a legal entity is a VIE shall be reconsidered if any of the following occur:

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

An enterprise reconsiders whether a VOE is a VIE, or vice versa, when there has been a change in the legal entity's design, such as the types of changes listed in paragraph 810-10-35-4. Reconsideration is not required simply because the legal entity incurs losses that are greater than the expected losses. Chapter 5 addresses VIE reconsideration events. [810-10-35-4]

In contrast, an enterprise is required to continually reassess which party is the VIE's primary beneficiary. Therefore, this reassessment is not triggered by a design change.

Question 6.7.10

Is reassessment of the primary beneficiary limited to the end of each reporting period?

Interpretive response: No. An enterprise may conclude it no longer meets the primary beneficiary criteria as the result of changes in facts and circumstances that occur at any time in the reporting period. The party that meets the power criterion or the significant variable interest criterion might change. As a result, the requirements to perform continual assessments are not limited to the end of each reporting period. See also Question 6.7.40.

Question 6.7.20

What are example situations that could result in a change to primary beneficiary status?

Interpretive response: Examples of situations that may result in a change to an entity's primary beneficiary status include the following (not exhaustive).

- Changes in the design of a VIE.
- Issuance of additional VIE variable interests, or the modification of the terms of existing variable interests.
- Changes to facts and circumstances regarding related parties that could affect the evaluation of the conditions in the related party tie-breaker test (see section 6.5.30).
- Triggering of contingent events that transfer power to another variable interest holder (see section 6.3.30).
- Acquisition or disposition of a VIE that results in a change in control.
- A call option becomes exercisable.
- Loss of rights held by the primary beneficiary (e.g. substantive kick-out or participating rights) due to the passage of time or other contractual changes.
- Other changes in contractual agreements that affect an enterprise's power over the VIE.

As discussed in Question 6.7.10, an enterprise is required to continually reassess which party is the VIE's primary beneficiary. While any of the above situations may result in a change to an entity's primary beneficiary, analysis of all facts and circumstances is required as part of performing continual reassessment.

Question 6.7.30

If a VIE's primary beneficiary changes, as of what date is the accounting effect recognized?

Interpretive response: If an enterprise identifies a change in a VIE's primary beneficiary status, it should determine the date on which the change occurred and recognize the accounting effect as of that date. See Question 6.7.20 for situations that could result in a change in primary beneficiary status.

Question 6.7.40

Does a change in a VIE's economic performance cause an enterprise to reevaluate whether it is the primary beneficiary?

Interpretive response: Perhaps. An enterprise is required to continually reassess which party (if any) is the VIE's primary beneficiary (see Question 6.7.10). A change in economic performance of a VIE may affect the analysis of the power criterion, specifically related to the activities that most significantly impact the VIE's economic performance. This is particularly relevant when the change in economics was unanticipated and affects the ongoing activities of the VIE.

For example, the activities that most significantly impact a VIE's economic performance may change due to a shift in the significance of one product relative to other products. Such a shift may be unanticipated if a sudden change in demand occurs for the product or its production costs suddenly change.

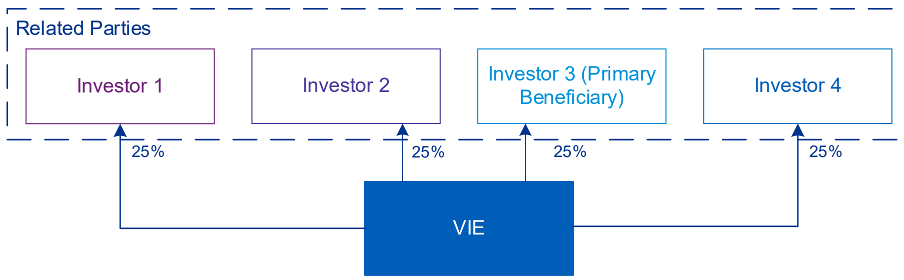
It is also possible that a change in economic performance could affect the evaluation of the significant variable interest criterion. However, we expect this to be rare because evaluating this criterion encompasses all possible economic scenarios. Nevertheless, it is possible that a variable interest could be eliminated due to a VIE's economic performance. For example, a tranche in an asset-backed structure may be permanently eliminated under the terms of the trust.

Further, there are circumstances in which drastic and unanticipated economic activity could effectively result in a change in design of a VIE and a reevaluation of whether a fee paid to a decision-maker represents a variable interest. See Question 3.8.190 for a discussion of the reevaluation of decision-maker fees.

Example 6.7.10
Primary beneficiary reconsideration at expiration of lock-up period

Background

The ownership interests in VIE are held equally by four investors. There are no other variable interests in VIE.



Based on VIE's governing documents, no investor is permitted to sell, transfer or encumber its ownership interest for five years subsequent to VIE's formation without the unanimous approval of all investors (i.e. lock-up period). As a result, the four investors are considered related parties; see section 6.5.20 for guidance on such restrictions. Investor 3 is determined to be the primary beneficiary based on an analysis of the criteria.

No reconsideration events occur during the lock-up period. VIE's governing documents have not been changed, and no transactions involving ownership interests have been executed by any parties.

Evaluation

At the expiration of the lock-up period, the contractual arrangement between the parties changes as a result of the passage of time. Therefore, the primary beneficiary should be reconsidered at the expiration of the lock-up period. If the investors are no longer considered related parties, each investor's variable interest in VIE is evaluated separately when determining the primary beneficiary.

6.8 FASB examples

Topic 810 includes examples about how to determine the primary beneficiary. These examples illustrate both:

— how to evaluate which party (if any) meets the power criterion; and
— how to evaluate whether a party that meets the power criterion also meets the significant variable interest criterion.

Excerpt from ASC 810-10

Variable Interest Entities

> Illustrations

>> Example 5: Identifying a Primary Beneficiary

55-93 The following cases are provided solely to illustrate the application of the guidance in paragraphs 810-10-25-38A through 25-38J related to the identification of a primary beneficiary:

a. Commercial mortgage-backed securitization (Case A)
b. Asset-backed collateralized debt obligation (Case B)
c. Structured investment vehicle (Case C)
d. Commercial paper conduit (Case D)
e. Guaranteed mortgage-backed securitization (Case E)
f. Residential mortgage-backed securitization (Case F)
g. Lease entity (Case G)
h. Collaboration—Joint venture arrangement (Case H)
i. Furniture manufacturing entity (Case I)
j. Investment fund 1—Annual and performance-based fees and additional interests (Case J)
k. Investment fund 2—Annual and performance-based fees and no additional interests (Case K)
l. eCommerce Entity (Case L).

55-94 The identification of a primary beneficiary, if any, in Cases A-L is based solely on the specific facts and circumstances presented. These Cases are hypothetical and are not meant to represent actual transactions in the marketplace. Although certain aspects of the Cases may be present in actual fact patterns, relevant facts and circumstances of a specific fact pattern or structure would need to be evaluated to reach an accounting conclusion. The Cases share the following assumptions:

a. The legal entities in Cases A–I and Case L are presumed to be VIEs. These presumptions should be understood as fact and not as conclusions based on the other facts and circumstances in each case. Case J provides an explanation as to why the legal entity is a VIE. Case K does not indicate whether the legal entity is a VIE because the decision maker does not have a variable interest in the legal entity.
b. All variable interests are presumed to be variable interests in the VIE as a whole, rather than variable interests in specified assets of the VIE, on the basis of the guidance in paragraphs 810-10-25-55 through 25-59.

55-95 In some Cases, certain fees are described as representing, or not representing, a variable interest on the basis of paragraphs 810-10-55-37 through 55-38. However, the Cases were not meant to illustrate the application of the guidance in those paragraphs, and additional facts would be necessary to determine which condition(s) resulted in the fee representing a variable interest. Specifically, certain Cases state whether certain fees are commensurate with the level of effort required to provide the related services and whether they are part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in similar arrangements negotiated at arm's length. Those presumptions should be understood as fact for purposes of reading each related Case and not as conclusions based on the other facts and circumstances described in each case. Finally, determining the primary beneficiary in accordance with the guidance in the Variable Interest Entities Subsections requires judgment and is on the basis of individual facts and circumstances of the VIE and the reporting entity with the variable interest or interests.

>>> Case A: Commercial Mortgage-Backed Securitization

55-96 A VIE is created and financed with $94 of investment grade 7-year fixed-rate bonds (issued in 3 tranches) and $6 of equity. All of the bonds are held by third-party investors. The equity is held by a third party, who is also the special servicer. The equity tranche was designed to absorb the first dollar risk of loss and to receive any residual return from the VIE. The VIE uses the proceeds to purchase $100 of BB-rated fixed-rate commercial mortgage loans with contractual maturities of 7 years from a transferor. The commercial mortgage loans contain provisions that require each borrower to pay the full scheduled interest and principal if the loan is extinguished prior to maturity. The transaction was marketed to potential bondholders as an investment in a portfolio of commercial mortgage loans with exposure to the credit risk associated with the possible default by the borrowers.

55-97 Each month, interest received from all of the pooled loans is paid to the investors in the fixed-rate bonds, in order of seniority, until all accrued interest on those bonds is paid. The same distribution occurs when principal payments are received.

55-98 If there is a shortfall in contractual payments from the borrowers or if the loan collateral is liquidated and does not generate sufficient proceeds to meet payments on all bond classes, the equity tranche and then the most subordinate bond class will incur losses, with further losses impacting more senior bond classes in reverse order of priority.

55-99 The transferor retains the primary servicing responsibilities. The primary servicing activities performed are administrative in nature and include remittance of payments on the loans, administration of escrow accounts, and collections of insurance claims. Upon delinquency or default by the borrower, the responsibility for administration of the loan is transferred from the transferor as the primary servicer to the special servicer. Furthermore, the special servicer, as the equity holder, has the approval rights for budgets, leases, and property managers of foreclosed properties.

55-100 The special servicer is involved in the creation of the VIE and required at the creation date that certain loans, which it deemed to be of high risk, be removed from the initial pool of loans that were going to be purchased by the VIE from the transferor. The special servicer also reviewed the VIE's governing documents to ensure that the special servicer would be allowed to act quickly and effectively in situations in which a loan becomes delinquent. The special servicer concluded the VIE's governing documents allowed the special servicer to adequately monitor and direct the performance of the underlying loans.

55-101 For its services as primary servicer, the transferor earns a fixed fee, calculated as a percentage of the unpaid principal balance on the underlying loans. The special servicer also earns a fixed fee, calculated as a percentage of the unpaid principal balance on the underlying loans. The fees paid to the primary and special servicer are both of the following:

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

No party has the ability to remove the primary servicer or the special servicer.

55-102 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide liquidity to the transferor to originate additional loans and to provide investors with the ability to invest in a pool of commercial mortgage loans.
b. The VIE was marketed to debt investors as a VIE that would be exposed to the credit risk associated with the possible default by the borrowers with respect to principal and interest payments, with the equity tranche designed to absorb the first dollar risk of loss. Additionally, the marketing of the transaction indicated that such risks would be mitigated by subordination of the equity tranche.
c. The VIE is not exposed to prepayment risk because the commercial mortgage loans contain provisions that require the borrower to pay the full scheduled interest and principal if the loan is extinguished prior to maturity.

55-103 The special servicer and the bondholders are the variable interest holders in the VIE. The fees paid to the transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38. The fees paid to the special servicer represent a variable interest on the basis of a consideration of the conditions in those paragraphs, specifically paragraph 810-10-55-37(c), because of the special servicer holding the equity tranche. If the special servicer was only receiving fees and did not hold the equity tranche and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-104 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the VIE's economic performance are the activities that most significantly impact the performance of the underlying assets. The special servicer has the ability to manage the VIE's assets that are delinquent or in default to improve the economic performance of the VIE. Additionally, the special servicer, as the equity holder, can approve budgets, leases, and property managers on foreclosed property. The special servicing activities are performed only upon delinquency or default of the underlying assets. However, a reporting entity's ability to direct the activities of a VIE 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. The special servicer's involvement in the design of the VIE does not, in isolation, result in the special servicer being the primary beneficiary of the VIE. However, in this situation, that involvement indicated that the special servicer had the opportunity and the incentive to establish arrangements that result in the special servicer being the variable interest holder with the power to direct the activities that most significantly impact the VIE's economic performance.

55-105 The bondholders of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE's economic performance.

55-106 The activities that the primary servicer has the power to direct are administrative in nature and do not most significantly impact the VIE's economic performance. In addition, the primary servicer, and its related parties, do not hold a variable interest in the VIE. Thus, the primary servicer cannot be the primary beneficiary of the VIE.

55-107 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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.

55-108 The special servicer, for its servicing activities, receives a fixed fee that provides it with the right to receive benefits of the VIE. The fees paid to the special servicer are both of the following:

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

Therefore, the fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). The special servicer, as the equity tranche holder, has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the VIE. As equity tranche holder, the special servicer is the most subordinate tranche and therefore absorbs the first dollar risk of loss and has the right to receive benefits, including the VIE's actual residual returns, if any.

55-109 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the special servicer would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.
b. As the equity tranche holder, it has the obligation to absorb losses of the VIE and the right to receive benefits from the VIE, either of which could potentially be significant to the VIE.

>>> Case B: Asset-Backed Collateralized Debt Obligation

55-110 A VIE is created and financed with $90 of AAA-rated fixed-rate debt securities, $6 of BB-rated fixed-rate debt securities, and $4 of equity. All debt securities issued by the VIE are held by third-party investors. The equity tranche is held 35 percent by the manager of the VIE and 65 percent by a third-party investor. The VIE uses the proceeds to purchase a portfolio of asset-backed securities with varying tenors and interest rates.

55-111 The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default by the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. The equity tranche was designed to absorb the first dollar risk of loss related to credit risk and interest rate risk and to receive any residual returns from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of investments in the portfolio.

55-112 The assets of the VIE are managed within the parameters established by the underlying trust documents. The parameters provide the manager with the latitude to manage the VIE's assets while maintaining an average portfolio rating of single B-plus or higher. If the average rating of the portfolio declines, the VIE's governing documents require that the manager's discretion in managing the portfolio be curtailed.

55-113 For its services, the manager earns a base, fixed fee, and a performance fee in which it receives a portion of the VIE's profit above a targeted return. The fees paid to the manager are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide the services
b. Part of 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 manager can be removed, **without cause** (as distinguished from **with cause**), by a simple majority decision of the AAA-rated debt holders. As the debt of the entity is widely dispersed, no one party has the ability to unilaterally remove the manager. If removal of the manager occurs, the manager will continue to hold a 35 percent equity interest in the VIE.

55-114 The third-party equity investor has rights that are limited to administrative matters.

55-115 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of asset-backed securities, to earn a positive spread between the interest that the VIE earns on its portfolio and the interest paid to the debt investors, and to generate management fees for the manager.

b. The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default by the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. Additionally, the marketing of the transaction indicated that such risks would be mitigated by the support from the equity tranche.
c. The equity tranche was designed to absorb the first dollar risk of loss related to credit risk and interest rate risk and to receive any residual returns from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of asset-backed securities in the portfolio.

55-116 The third-party debt investors, the third-party equity investor, and the manager are the variable interest holders in the VIE. The fees paid to the manager also represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the manager holding the equity tranche. If the manager was only receiving fees and did not hold the equity tranche and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-117 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of the VIE's portfolio of assets. Thus, the activities that most significantly impact the VIE's economic performance are the activities that most significantly impact the performance of the portfolio of assets. The manager has the ability to manage the VIE's assets within the parameters of the trust documents. If the average rating of the portfolio declines, the VIE's governing documents require that the manager's discretion in managing the portfolio be curtailed. Although the AAA-rated debt holders can remove the manager without cause, no one party has the unilateral ability to exercise the kick-out rights over the manager. Therefore, such kick-out rights would not be considered in this primary beneficiary analysis.

55-118 The debt holders of the VIE do not have voting rights or other rights that provide them with the power to direct activities that most significantly impact the VIE's economic performance. Although the AAA-rated debt holders can remove the manager without cause, no one party has the unilateral ability to exercise the kick-out rights over the manager.

55-119 The third-party equity investor has the power to direct certain activities. However, the activities that the third-party equity investor has the power to direct are administrative and do not most significantly impact the VIE's economic performance.

55-120 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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 manager, as the 35 percent equity tranche holder, has the obligation to absorb losses and the right to receive benefits. As equity tranche holder, the manager has the most subordinate tranche and therefore absorbs 35 percent of the first dollar risk of loss and has the right to receive 35 percent of any residual benefits. The fees paid to the manager are both of the following:

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

Therefore, the fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). Through the equity interest, the manager has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

55-121 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the manager would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance (and no single entity has the unilateral ability to exercise kick-out rights).
b. Through its equity interest, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

>>> Case C: Structured Investment Vehicle

55-122 A VIE is created and financed with $94 of AAA-rated fixed-rate short-term debt with a 6-month maturity and $6 of equity. The VIE uses the proceeds to purchase a portfolio of floating-rate debt with an average life of four years and varying interest rates and short-term deposits with highly rated banks. The short-term debt securities and equity are held by multiple third-party investors. Upon maturity of the short-term debt, the VIE will either refinance the debt with existing investors or reissue the debt to new investors at existing market rates.

55-123 The primary purpose of the VIE is to generate profits by maximizing the spread it earns on its asset portfolio and its weighted-average cost of funding. The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality debt with exposure to the credit risk associated with the possible default by the issuers of the debt in the portfolio. The equity tranche is designed to absorb the first dollar risk of loss related to credit, liquidity, changes in fair value, and interest rate risk and to receive any benefit from a favorable change in credit, changes in fair value, and interest rates.

55-124 The VIE is exposed to liquidity risk because the average tenor of the assets is greater than its liabilities. To mitigate liquidity risk, the VIE maintains a certain portion of its assets in short-term deposits with highly rated banks. The VIE has not entered into a liquidity facility to further mitigate liquidity risk.

55-125 The sponsor of the VIE was significantly involved with the creation of the VIE. The sponsor performs various functions to manage the operations of the VIE, which include:

a. Investment management—This management must adhere to the investment guidelines established at inception of the VIE. These guidelines include descriptions of eligible investments and requirements regarding the composition of the credit portfolio (including limits on country risk exposures, diversification limits, and ratings requirements).
b. Funding management—This function provides funding management and operational support in relation to the debt issued and the equity with the objective of minimizing the cost of borrowing, managing interest rate and liquidity risks, and managing the capital adequacy of the VIE.
c. Defeasance management—An event of defeasance occurs upon the failure of the rating agencies to maintain the ratings of the debt securities issued by the VIE at or above certain specified levels. In the event of defeasance, the sponsor is responsible for overseeing the orderly liquidation of the investment portfolio and the orderly discharge of the VIE's obligations. This includes managing the market and credit risks of the portfolio.

55-126 For its services, the sponsor receives a fixed fee, calculated as an annual percentage of the aggregate equity outstanding, and a performance-based fee, calculated as a percentage of the VIE's profit above a targeted return. The fees paid to the sponsor are both of the following:

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

55-127 The debt security holders of the VIE have no voting rights. The equity holders have limited voting rights that are typically limited to voting on amendments to the constitutional documents of the VIE.

55-128 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of high-quality debt, to maximize the spread it earns on its asset portfolio over its weighted-average cost of funding, and to generate management fees for the sponsor.
b. The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality debt with exposure to the credit risk associated with the possible default by the issuers of the debt in the portfolio.
c. The equity tranche is negotiated to absorb the first dollar risk of loss related to credit, liquidity, fair value, and interest rate risk and to receive a portion of the benefit from a favorable change in credit, fair value, and interest rates.

d. The principal risks to which the VIE is exposed include credit, interest rate, and liquidity risk.

55-129 The third-party debt investors, the third-party equity investors, and the sponsor are the variable interest holders in the VIE. The fees paid to the sponsor represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the sponsor having an implicit variable interest in the VIE as discussed in paragraph 810-10-55-132. If the sponsor was only receiving fees and did not have the implicit variable interest and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-130 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the performance of the VIE's portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the VIE's economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The sponsor manages the VIE's investment, funding, and defeasance activities. The fact that the sponsor was significantly involved with the creation of the VIE does not, in isolation, result in the sponsor being the primary beneficiary of the VIE. However, the fact that the sponsor was involved with the creation of the VIE indicated that the sponsor had the opportunity and the incentive to establish arrangements that result in the sponsor being the variable interest holder with the power to direct the activities that most significantly impact the VIE's economic performance.

55-131 The debt security holders of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE's economic performance. Although the equity holders have voting rights, they are limited to voting on amendments to the constitutional documents of the VIE, and those rights do not provide the equity holders with the power to direct the activities that most significantly impact the VIE's economic performance.

55-132 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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 sponsor considered whether it had an implicit financial responsibility to ensure that the VIE operates as designed. Based on paragraphs 810-10-25-51 and 810-10-25-54, the sponsor determined that it has an implicit financial responsibility and that such obligation requires the sponsor to absorb losses that could potentially be significant to the VIE. This determination was influenced by the sponsor's concern regarding the risk to its reputation in the marketplace if the VIE did not operate as designed. The fees paid to the sponsor are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide the services

b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b).

55-133 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the sponsor would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.
b. Through its implicit financial responsibility to ensure that the VIE operates as designed, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE.

>>> Case D: Commercial Paper Conduit

55-134 A VIE is created by a reporting entity (the sponsor) and financed with $98 of AAA-rated fixed-rate short-term debt with a 3-month maturity and $2 of subordinated notes. The VIE uses the proceeds to purchase a portfolio of medium-term assets with average tenors of three years. The asset portfolio is obtained from multiple sellers. The short-term debt and subordinated notes are held by multiple third-party investors. Upon maturity of the short-term debt, the VIE will either refinance the debt with existing investors or reissue the debt to new investors.

55-135 The sponsor of the VIE provides credit enhancement in the form of a letter of credit equal to 5 percent of the VIE's assets and it provides a liquidity facility to fund the cash flow shortfalls on 100 percent of the short-term debt. Cash flow shortfalls could arise due to a mismatch between collections on the underlying assets of the VIE and payments due to the short-term debt holders or to the inability of the VIE to refinance or reissue the short-term debt upon maturity.

55-136 A credit default of the VIE's assets resulting in deficient cash flows is absorbed as follows:

a. First by the subordinated note holders
b. Second by the sponsor's letter of credit
c. Third by the short-term debt holders.

The sponsor's liquidity facility does not advance against defaulted assets.

55-137 The VIE is exposed to liquidity risk because the average life of the assets is greater than that of its liabilities. The VIE enters into a liquidity facility with the sponsor to mitigate liquidity risk.

55-138 The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. The subordinated notes were designed to absorb the first dollar risk of loss related to credit. The VIE is marketed to all investors as having a low probability of credit exposure due to the nature of the assets obtained. Furthermore, the VIE is marketed to the short-term debt holders as having protection from liquidity risk due to the liquidity facility provided by the sponsor.

55-139 The sponsor of the VIE performs various functions to manage the operations of the VIE. Specifically, the sponsor:

a. Establishes the terms of the VIE
b. Approves the sellers permitted to sell to the VIE
c. Approves the assets to be purchased by the VIE
d. Makes decisions regarding the funding of the VIE including determining the tenor and other features of the short-term debt issued
e. Administers the VIE by monitoring the assets, arranging for debt placement, compiling monthly reports, and ensuring compliance with the VIE's credit and investment policies.

55-140 For providing the letter of credit, liquidity facility, and management services, the sponsor receives fixed fees that are calculated as an annual percentage of the asset value. The short-term debt holders and subordinated note holders have no voting rights. The fees paid to the sponsor for its management services are both of the following:

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

55-141 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of highly rated medium-term assets, to provide the multiple sellers to the VIE with access to lower-cost funding, to earn a positive spread between the interest that the VIE earns on its asset portfolio and its weighted-average cost of funding, and to generate fees for the sponsor.
b. The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. The subordinated debt is designed to absorb the first dollar risk of loss related to credit and interest rate risk. The VIE is marketed to all investors as having a low probability of credit loss due to the nature of the assets obtained. Furthermore, the VIE is marketed to the short-term debt holders as having protection from liquidity risk due to the liquidity facility provided by the sponsor.
c. The principal risks to which the VIE is exposed include credit, interest rate, and liquidity.

55-142 The short-term debt holders, the third-party subordinated note holders, and the sponsor are the variable interest holders in the VIE. The letter of credit and liquidity facility provided by the sponsor protect holders of other variable interests from suffering losses of the VIE. Therefore, the sponsor's fees for the letter of credit and liquidity facility are not eligible for the evaluation in paragraph 810-10-55-37 and are variable interests in the VIE. The fees paid to the sponsor for its management services represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38 , specifically paragraph 810-10-55-37(c), because of the sponsor providing the letter of credit and liquidity facility and the fees for the letter of credit and liquidity facility. If the sponsor was only receiving management fees, did not provide the letter of credit and liquidity facility, and did not receive fees for the letter of credit and liquidity facility and if its related parties did not hold any variable interests in the VIE, then the management fees would not be a variable interest.

55-143 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the performance of the VIE's portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the VIE's economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The sponsor manages the operations of the VIE. Specifically, the sponsor establishes the terms of the VIE, approves the sellers permitted to sell to the VIE, approves the assets to be purchased by the VIE, makes decisions about the funding of the VIE including determining the tenor and other features of the short-term debt issued, and administers the VIE by monitoring the assets, arranging for debt placement, and ensuring compliance with the VIE's credit and investment policies. The fact that the sponsor was significantly involved with the creation of the VIE does not, in isolation, result in the sponsor being the primary beneficiary of the VIE. However, the fact that the sponsor was involved with the creation of the VIE may indicate that the sponsor had the opportunity and the incentive to establish arrangements that result in the sponsor being the variable interest holder with the power to direct the activities that most significantly impact the VIE's economic performance.

55-144 The short-term debt holders and subordinated note holders of the VIE have no voting rights and no other rights that provide them with power to direct the activities that most significantly impact the VIE's economic performance.

55-145 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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 fees paid to the sponsor for its management services are both of the following:

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

Therefore, the management fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). However, the sponsor still, through its letter of credit and liquidity facility fees, receives benefits from the VIE that could potentially be significant to the VIE. The sponsor, through its letter of credit and liquidity facility, also has the obligation to absorb losses of the VIE that could potentially be significant to the VIE.

55-146 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the sponsor would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.
b. Through its letter of credit and liquidity facility, the sponsor has the obligation to absorb losses that could potentially be significant to the VIE, and, through its fees for the letter of credit and liquidity facility, the sponsor has the right to receive benefits that could potentially be significant to the VIE.

>>> Case E: Guaranteed Mortgage-Backed Securitization

55-147 A VIE is created and financed with $100 of a single class of investment-grade 30-year fixed-rate debt securities. The VIE uses the proceeds to purchase $100 of 30-year fixed-rate residential mortgage loans from the transferor. The VIE enters into a guarantee facility that absorbs 100 percent of the credit losses incurred on the VIE's assets. The assets acquired by the VIE are underwritten by the transferor in accordance with the parameters established by the guarantor. Additionally, all activities of the VIE are prespecified by the trust agreement and servicing guide, which are both established by the guarantor. No critical decisions are generally required for the VIE unless default of an underlying asset is reasonably foreseeable or occurs.

55-148 The transaction was marketed to potential debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the guarantor and to the prepayment risk associated with the underlying loans of the VIE. Each month, the security holders receive interest and principal payments in proportion to their percentage ownership of the underlying loans.

55-149 If there is a shortfall in contractually required loan payments from the borrowers or if the loan is foreclosed on and the liquidation of the underlying property does not generate sufficient proceeds to meet the required payments on all securities, the guarantor will make payments to the debt securities holders to ensure timely payment of principal and accrued interest on the debt securities.

55-150 The guarantor also serves as the master servicer for the VIE. As master servicer, the guarantor services the securities issued by the VIE. Generally, if a mortgage loan is 120 days (or 4 consecutive months) delinquent, and if other circumstances are met, the guarantor has the right to buy the loan from the VIE. The master servicer can only be removed for a material breach in its obligations. As compensation for the guarantee and services provided, the guarantor receives a fee that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

55-151 As master servicer, the guarantor also is responsible for supervising and monitoring the servicing of the residential mortgage loans (primary servicing). The VIE's governing documents provide that the guarantor is responsible for the primary servicing of the loans; however, the guarantor is allowed to, and does, hire the transferor to perform primary servicing activities that are conducted under the supervision of the guarantor. The guarantor monitors the primary servicer's performance and has the right to remove the primary servicer at any time it considers such a removal to be in the best interest of the security holders.

55-152 The primary servicing activities are performed under the servicing guide established by the guarantor. Examples of the primary servicing activities include collecting and remitting principal and interest payments, administering escrow accounts, and managing default. When a loan becomes delinquent or it is reasonably foreseeable of becoming delinquent, the primary servicer can propose a default mitigation strategy in which the guarantor can approve, reject, or require another course of action if it considers such action is in the best interest of the security holders. As compensation for servicing the underlying loans, the transferor receives a fee that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

55-153 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of residential mortgage loans with a third-party guarantee for 100 percent of the principal and interest payments due on the mortgage loans in the VIE, to provide the transferor to the VIE with access to liquidity for its originated loans and an ongoing servicing fee, and to generate fees for the guarantor.
b. The transaction was marketed to potential debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the guarantor and prepayment risk associated with the underlying assets of the VIE.
c. The principal risks to which the VIE is exposed include credit risk of the underlying assets, prepayment risk, and the risk of fluctuations in the value of the underlying real estate. The credit risk of the underlying assets and the risk of fluctuations in the value of the underlying real estate are fully absorbed by the guarantor.

55-154 The debt securities holders and the guarantor are the variable interest holders in the VIE. The fees paid to the transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38. The guarantee arrangement protects holders of other variable interests from suffering losses in the VIE because the guarantor is required to fully absorb the credit risk of the underlying assets of the VIE and the risk of fluctuations in the value of the underlying real estate. Therefore, the guarantor's fees are not eligible for the evaluation in paragraph 810-10-55-37.

55-155 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the VIE's economic performance are the activities that most significantly impact the performance of the underlying assets. The guarantor, who is also the master servicer, has the ability (through establishment of the servicing terms, to appoint and remove the primary servicer, to direct default mitigation, and to purchase defaulted assets) to manage the VIE's assets that become delinquent (or may become delinquent in the reasonably foreseeable future) to improve the economic performance of the VIE.

55-156 Prepayment risk is also a risk that the VIE was designed to create and pass through. However, no variable interest holder has the power to direct activities related to such risk.

55-157 Because the guarantor is able to appoint and replace the primary servicer and direct default mitigation, the primary servicer does not have the power to direct the activities that most significantly impact the VIE's economic performance. In addition, the primary servicer and its related parties do not hold a variable interest in the VIE. Thus, the primary servicer cannot be the primary beneficiary of the VIE. Furthermore, the security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the VIE's economic performance.

55-158 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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 guarantor, through its fee arrangement, receives benefits, which may or may not potentially be significant under this analysis; however, the guarantor has the obligation to absorb losses of the VIE that could potentially be significant through its guarantee obligation. Therefore, the fees are not eligible for the evaluation in paragraph 810-10-25-38H, and they should be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b).

55-159 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the guarantor would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.
b. Through its guarantee, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE.

>>> Case F: Residential Mortgage-Backed Securitization

55-160 A VIE is created and financed with $100 of 30-year fixed-rate debt securities. The securities are issued in 2 tranches (a $90 senior tranche and a $10 residual tranche). The senior tranche securities are investment grade and are widely dispersed among third-party investors. The residual tranche securities are held by the transferor. The VIE uses the proceeds to purchase $100 of 30-year fixed-rate residential mortgage loans from a transferor. A default on the underlying loans is absorbed first by the residual tranche held by the transferor. All activities of the VIE are prespecified by a pooling and servicing agreement for the transaction. No critical decisions are generally required for the VIE unless default of an underlying asset is reasonably foreseeable or occurs.

55-161 The transaction was marketed to potential senior debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the underlying loan borrowers and to the prepayment risk associated with the underlying loans of the VIE. Each month the security holders receive interest and principal payments in proportion to their percentage of ownership of the underlying loans. The residual tranche was designed to provide a credit enhancement to the transaction and to absorb the first dollar risk of loss related to credit.

55-162 The primary servicing responsibilities are retained by the transferor. No party has the ability to remove the transferor as servicer.

55-163 The servicing activities are performed in accordance with the pooling and servicing agreement. Examples of the servicing activities include collecting and remitting principal and interest payments, administering escrow accounts, monitoring overdue payments, and overall default management. Default management includes evaluating the borrower's financial condition to determine which loss mitigation strategy (specified in the pooling and servicing agreement) will maximize recoveries on a particular loan. The acceptable default management strategies are limited to the actions specified in the pooling and servicing agreement and include all of the following:

a. Modifying the terms of loans when default is reasonably foreseeable
b. Temporary forbearance on collections of principal and interest (such amounts would be added to the unpaid balance on the loan)
c. Short sales in which the servicer allows the underlying borrower to sell the mortgaged property even if the anticipated sale price will not permit full recovery of the contractual loan amounts.

55-164 As compensation for servicing the underlying loans, the transferor receives a fee, calculated monthly as a percentage of the unpaid principal balance on the underlying loans. Although the servicing activities, particularly managing default, are required to be performed in accordance with the pooling and servicing agreement, the transferor, as servicer, has discretion in determining which strategies within the pooling and servicing agreement to utilize to attempt to maximize the VIE's economic performance. The fees paid to the transferor are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide those services
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.

55-165 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of residential mortgage loans and to provide the transferor to the VIE with access to liquidity for its originated loans and an ongoing servicing fee and potential residual returns.
b. The transaction was marketed to potential senior debt security holders as an investment in a portfolio of residential mortgage loans with credit enhancement provided by the residual tranche and prepayment risk associated with the underlying assets of the VIE. The marketing of the transaction indicated that credit risk would be mitigated by the subordination of the residual tranche.
c. The principal risks to which the VIE is exposed include credit of the underlying assets, prepayment risk, and the risk of fluctuations in the value of the underlying real estate.

55-166 The debt security holders and the transferor are the variable interest holders in the VIE. The fee paid to the transferor (in its role as servicer) represents a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the transferor holding the residual tranche. If the transferor was only receiving fees and did not hold the residual tranche and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-167 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the VIE's economic performance are the activities that most significantly impact the performance of the underlying assets. The transferor, as servicer, has the ability to manage the VIE's assets that become delinquent (or are reasonably foreseeable of becoming delinquent) to improve the economic performance of the VIE. Additionally, no party can remove the transferor in its role as servicer. The default management activities are performed only after default of the underlying assets or when default is reasonably foreseeable. However, a reporting entity's ability to direct the activities of a VIE 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.

55-168 Prepayment risk is also a risk that the VIE was designed to create and pass through. However, no variable interest holder has the power to direct matters related to such risk.

55-169 The senior security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the VIE's economic performance.

55-170 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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 transferor, through its residual tranche ownership, has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the VIE. The fees paid to the transferor are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide those services
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.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H and should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b).

55-171 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the transferor would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.
b. Through its residual tranche ownership, it has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the VIE.

>>> Case G: Lease Entity

55-172 A VIE is created and financed with $950 of 5-year fixed-rate debt and $50 of equity. The VIE uses the proceeds from the issuance to purchase an asset to be leased to a lessee with an AA credit rating. The equity is subordinate to the debt because the debt is paid before any cash flows are available to the equity investors. The lease has a five-year term and is classified as a direct financing lease by the lessor and as an operating lease by the lessee. The lessee, however, is considered the owner of the underlying asset for tax purposes and, thus, receives tax depreciation benefits.

55-173 The lessee is required to provide a first-loss residual value guarantee for the expected future value of the underlying asset at the end of five years (the option price) up to a specified percentage of the option price, and it has a fixed-price purchase option to acquire the underlying asset for the option price. If the lessee does not exercise the fixed-price purchase option at the end of the lease term, the lessee is required to remarket the underlying asset on behalf of the VIE. If the underlying asset is sold for an amount less than the option price, the lessee is required to pay the VIE the difference between the option price and the sales proceeds, which is not to exceed a specified percentage of the option price. If the underlying asset is sold for an amount greater than the option price, the lessee is entitled to the excess of the sales proceeds over the option price. A third-party residual value guarantor provides a very small additional residual value guarantee to the lessor VIE, which allows the lessor to achieve direct financing lease treatment.

55-174 The governing documents for the VIE do not permit the VIE to buy additional assets or sell existing assets during the five-year holding period, and the terms of the lease agreement and the governing documents for the VIE do not provide the equity holders with the power to direct any activities of the VIE. The VIE was formed so that the lessee would have rights to use the underlying asset under an operating lease and would retain substantially all of the risks and rewards from appreciation or depreciation in value of the underlying asset.

55-175 The transaction was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by an underlying asset that is leased that would provide a fixed-rate return to debt holders equivalent to AA-rated assets. The return to equity investors is expected to be slightly greater than the return to the debt investors because the equity is subordinated to the debt.

55-176 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purpose for which the VIE was created was to provide the lessee with use of the underlying asset for five years with substantially all of the rights and obligations of ownership, including tax benefits.
b. The VIE was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by an underlying asset that is leased that would provide a fixed-rate return to debt holders equivalent to AA-rated assets. The return to equity investors is expected to be slightly greater than the return to the debt investors because the equity is subordinated to the debt.
c. The residual value guarantee effectively transfers substantially all of the risk associated with the underlying asset (that is, decreases in value) to the lessee and the fixed-price purchase option effectively transfers substantially all of the rewards from the underlying asset (that is, increases in value) to the lessee.
d. The VIE is designed to be exposed to the risks associated with a cumulative change in fair value of the underlying asset at the end of five years as well as credit risk related to the potential default by the lessee of its contractually required lease payments.

55-177 The debt investors, the equity investors, and the lessee are the variable interest holders in the VIE.

55-178 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the fair value of the underlying asset and the credit of the lessee. The lessee's maintenance and operation of the underlying asset has a direct effect on the fair value of the underlying asset, and the lessee directs the remarketing of the underlying asset. The lessee also has the ability to increase the benefits it can receive and limit the losses it can suffer by the manner in which it uses the underlying asset and how it remarkets the underlying asset.

55-179 The debt holders do not have the power to direct activities that most significantly impact the VIE's economic performance. Although the equity holders establish the terms of the lease agreement, the terms of the lease agreement do not provide the equity holders with the power to direct activities that most significantly impact the VIE's economic performance.

55-180 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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 lessee has both the obligation to absorb losses that could potentially be significant to the VIE and the right to receive benefits that could potentially be significant to the VIE through the residual value guarantee and the purchase option, respectively.

55-181 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the lessee would be deemed the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.
b. Through its residual value guarantee and purchase option, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

>>> Case H: Collaboration—Joint Venture Arrangement

55-182 The following Cases illustrate the application of the guidance in paragraphs 810-10-25-38A through 25-38J related to the determination of the entity that has the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.

a. Joint decision making, different activities (Case H1)
b. Separate decision making, different activities (Case H2)
c. Separate decision making, same activities (Case H3)
d. Separate decision making, similar and different activities (Case H4).

55-183 Each of the Cases share the following assumptions:

a. Reporting Entity A and Reporting Entity B form a VIE to manufacture, distribute, and sell a beverage. The VIE is funded with $95 million of 20-year fixed-rate debt and $5 million of equity. The debt is widely dispersed among third-party investors. The equity is held by Reporting Entity A and Reporting Entity B. Reporting Entity A and Reporting Entity B are not related parties.
b. Reporting Entity A and Reporting Entity B each have 50 percent of the voting rights and each represents 50 percent of the board of directors.
c. Reporting Entity A is a beverage manufacturer and distributor. Reporting Entity B is also a beverage manufacturer and distributor.

>>>> Case H1: Joint Decision Making, Different Activities

55-184 Reporting Entity A is responsible for manufacturing the beverage. Reporting Entity B is responsible for distributing and selling the beverage. Decisions about the manufacturing, distributing, and selling of the beverage require the consent of both Reporting Entity A and Reporting Entity B. All other decisions about the VIE are jointly decided by Reporting Entity A and Reporting Entity B through their voting interests and equal board representation. Any matters that cannot be resolved or agreed upon must be resolved through a third-party arbitration process.

55-185 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined that the primary purpose for which the VIE was created was to provide Reporting Entity A with access to Reporting Entity B's distribution and sales network and for Reporting Entity B to gain access to Reporting Entity A's manufacturing process and technology.

55-186 Reporting Entity A and Reporting Entity B (through their equity investment) and the debt investors are the variable interest holders in the VIE.

55-187 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the manufacturing of the beverage and by the selling and distributing of the beverage. Thus, the activities that significantly impact the VIE's economic performance are the activities that significantly impact the manufacturing of the beverage and the selling and distributing of the beverage.

55-188 Paragraph 810-10-25-38D provides that if a reporting entity determines that power is, in fact, shared among multiple 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.

55-189 Reporting Entity A and Reporting Entity B share the power to direct the activities that will most significantly impact the economic performance of the VIE through their ability to make decisions about the manufacturing, distributing, and selling of the beverage and because of the fact that those decisions require each party's consent.

55-190 The debt holders of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE's economic performance.

55-191 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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. Reporting Entity A and Reporting Entity B both have the obligation to absorb losses and the right to receive benefits that could potentially be significant to the VIE through their equity interests.

55-192 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the VIE does not have a primary beneficiary because the power to direct the activities of the VIE that most significantly impact the VIE's economic performance, is, in fact, shared among multiple parties (Reporting Entity A and Reporting Entity B) such that no one party has the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.

>>>> Case H2: Separate Decision Making, Different Activities

55-193 Assume that decisions about the manufacturing, distributing, and selling of the beverage do not require the consent of both Reporting Entity A and Reporting Entity B. Each reporting entity would be required to identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would be the primary beneficiary of the VIE. Because decisions about these activities do not require the consent of both Reporting Entity A and Reporting Entity B, power would not be considered shared, and either Reporting Entity A or Reporting Entity B would be the primary beneficiary of the VIE, on the basis of which party has the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.

>>>> Case H3: Separate Decision Making, Same Activities

55-194 Assume that Reporting Entity A and Reporting Entity B each manufacture, distribute, and sell the beverage in different locations, but decisions about these activities do not require the consent of both Reporting Entity A and Reporting Entity B. That is, each reporting entity is responsible for the same activities. Because decisions about these activities do not require the consent of both Reporting Entity A and Reporting Entity B, power would not be considered shared.

55-195 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, the party, if any, with the power over the majority of those activities shall be considered to have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. If no party directs the majority of those activities, the VIE does not have a primary beneficiary.

55-196 If Reporting Entity A or Reporting Entity B has power over the majority of those activities, then that party would be the primary beneficiary of the VIE.

>>>> Case H4: Separate Decision Making, Similar and Different Activities

55-197 Assume that Reporting Entity A and Reporting Entity B are each responsible for manufacturing the beverage, but Reporting Entity B is also responsible for all of the distributing and selling of the beverage, and decisions about the manufacturing, distributing, and selling of the beverage do not require the consent of both Reporting Entity A and Reporting Entity B. Each reporting entity would be required to identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would be the primary beneficiary of the VIE. That is, power would not be considered shared, and either Reporting Entity A or Reporting Entity B would be the primary beneficiary of the VIE. However, 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, the party, if any, with the power over the majority of those activities shall be considered to have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. If no party directs the majority of those activities, the VIE does not have a primary beneficiary.

55-198 Reporting Entity B may conclude that its power over some of the manufacturing of the beverage, combined with its power over all of the distributing and selling of the beverage, results in its being the party with the power to direct the activities that most significantly impact the VIE's economic performance. However, if Reporting Entity B were to conclude that the distributing and selling of the beverage did not significantly impact the economic performance of the VIE, then the primary beneficiary of the VIE would be the party, if any, with the power over the majority of the manufacturing of the beverage.

>>> Case I: Furniture Manufacturing Entity

55-199 A VIE is created by a furniture manufacturer and a financial investor to manufacture and sell wood furniture to retail customers in a particular geographic region. The VIE was created because the furniture manufacturer has no viable distribution channel in that particular geographic region. The VIE is established with $100 of equity, contributed by the furniture manufacturer, and $3 million of 10-year fixed-rate debt, provided by a financial investor. The furniture manufacturer establishes the sales and marketing strategy of the VIE, manages the day-to-day activities of the VIE, and is responsible for preparing and implementing the annual budget for the VIE. The VIE has a distribution contract with a third party that does not represent a variable interest in the VIE. Interest is paid to the fixed-rate debt holder (the financial investor) from operations before funds are available to the equity holder. The furniture manufacturer has guaranteed the fixed-rate debt to the financial investor. The debt agreement includes a clause such that if there is a materially adverse change that materially impairs the ability of the VIE and the furniture manufacturer to pay the debt, then the financial investor can take possession of all the assets of the VIE. An independent third party must objectively determine whether a materially adverse change has occurred on the basis of the terms of the debt agreement (an example of a materially adverse change under the debt agreement is the bankruptcy of the VIE).

55-200 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purpose for which the VIE was created was to enable the furniture manufacturer to extend its existing business line into a particular geographic region that lacked a viable distribution channel.
b. The VIE was marketed to the financial investor as a fixed-rate investment in a retail operating entity, supported by the furniture manufacturer's expertise and guarantee.
c. The furniture manufacturer's guarantee of the debt effectively transfers all of the operating risk of the VIE to the furniture manufacturer.

55-201 The furniture manufacturer and the financial investor (debt holder) are the variable interest holders in the VIE.

55-202 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the operations of the VIE because the operating cash flows of the VIE are used to repay the financial investor. Thus, the activities that most significantly impact the VIE's economic performance are the operating activities of the VIE. The furniture manufacturer has the ability to establish the sales and marketing strategy of the VIE and manage the day-to-day activities of the VIE.

55-203 The debt holder has the power to take possession of all of the assets of the VIE if there is a materially adverse change under the debt agreement. However, the debt holder's rights under the materially adverse change clause represent **protective rights**. Protective rights held by other parties do not preclude a reporting entity from having the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Protective rights are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the VIE to which they relate. The debt holder's rights protect the interests of the debt holder; however, the VIE's economic performance is most significantly impacted by the activities over which the furniture manufacturer has power. The debt holder's protective rights do not prevent the furniture manufacturer from having the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.

55-204 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits that could potentially be significant to the VIE. The furniture manufacturer has the obligation to absorb losses that could potentially be significant through its equity interest and debt guarantee and the right to receive benefits that could potentially be significant through its equity interest.

55-205 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the furniture manufacturer would be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.
b. Through its equity interest and debt guarantee, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and

the right to receive benefits from the VIE that could potentially be significant to the VIE.

>>> Case J: Investment Fund 1—Annual and Performance-Based Fees and Additional Interests

55-205L A fund manager (general partner) creates and sells partnership interests in an investment fund (limited partnership) to external investors (limited partners). The partnership interests were marketed to the limited partners as an opportunity to generate returns by allowing the general partner to have discretion to determine how to invest the fund's assets provided that the investments are consistent with the defined parameters and objectives set forth in the limited partnership agreement. The general partner is not liable for any losses beyond the interest that the general partner owns in the fund. The general partner's ownership interests in the fund are expected to absorb more than an insignificant amount of the fund's expected losses and receive more than an insignificant amount of the fund's expected residual returns.

55-205M The individual limited partners do not hold any substantive rights that would affect the **decision-making authority** of the general partner, but they can redeem their interests within particular limits set forth by the fund. The limited partners do not have either of the following abilities:

a. The ability to remove the general partner from its decision-making authority or to dissolve (liquidate) the fund **without cause** (as distinguished from **with cause**)
b. The ability to block or participate in certain significant financial and operating decisions of the limited partnership that are made in the **ordinary course of business**.

55-205N The at-risk equity holders (as a group) do not have the ability to direct the activities that most significantly impact the economic performance of the fund on the basis of paragraph 810-10-55-205M(a) through (b). Therefore, the fund is a VIE because the condition in paragraph 810-10-15-14(b)(1)(ii) is met.

55-205O The general partner is paid an annual fixed fee for the assets under management and a performance-based fee based on the fund's profits if it achieves a specified annual profit level. The annual and performance-based fees paid to the general partner are both of the following:

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

55-205P To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined all of the following:

a. The fund is designed to provide limited partners with exposure to the risks and returns of the fund.

b. The fund was marketed to potential investors as an investment in a pool of securities with exposure to specific enterprise risks, market liquidity, and general market volatility of the investments. The limited partners have granted the general partner power to direct the activities that most significantly impact the VIE's economic performance, which include management of their invested capital, on the basis of the prior performance of the general partner.
c. The fee structure is designed to provide greater compensation to the general partner if the fund generates returns for the third-party limited partners that are above the specified profit level. The specified profit level is based on the activities of the fund and the nature of the fund's assets. While the general partner's fee structure may provide an incentive for the general partner to take additional risk to realize its performance-based fee, the annual and performance-based fees are designed to do all of the following:
    1. Provide compensation to the general partner for its services that is commensurate with the level of effort required to provide the services
    2. Include only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

55-205Q The general partner and the limited partners are the variable interest holders in the VIE. The fees paid to the general partner (in its role as fund manager) represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the general partner holding ownership interests that are expected to absorb more than an insignificant amount of the fund's expected losses and receive more than an insignificant amount of the fund's expected residual returns. If the general partner was only receiving fees and did not hold ownership interests and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-205R Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of the VIE's managed securities portfolio. Thus, the activities that most significantly impact the VIE's economic performance are the activities that significantly impact the performance of the managed securities portfolio.

55-205S The general partner manages the operations of the VIE. Specifically, the general partner establishes the terms of the VIE, approves the assets to be purchased and sold by the VIE, and administers the VIE by monitoring the assets and ensuring compliance with the VIE's investment policies. The fact that the general partner was significantly involved with the creation of the VIE does not, in isolation, result in the general partner being the primary beneficiary of the VIE. However, the fact that the general partner was involved with the creation of the VIE may indicate that the general partner had the opportunity and the incentive to establish arrangements that result in the general partner being the variable interest holder with the power to direct the activities that most significantly impact the VIE's economic performance.

55-205T The limited partners of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE's economic performance.

55-205U If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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 annual and performance-based fees paid to the general partner are both of the following:

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

Therefore, the annual and performance-based fees meet the criteria in paragraph 810-10-25-38H and should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). Additionally, the general partner, through its investment in the fund, has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

55-205V On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the general partner would be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.
b. Through its investment in the fund, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

>>> Case K: Investment Fund 2—Annual and Performance-Based Fees and No Additional Interests

55-205W A fund manager (general partner) creates and sells partnership interests in an investment fund (limited partnership) to external investors (limited partners). The partnership interests were marketed to the investors as an opportunity to generate significant returns by allowing the general partner to have discretion to determine how to invest the fund's assets provided that the investments are consistent with the defined parameters and objectives set forth in the limited partnership agreement. None of the limited partners are related parties of the general partner. The general partner does not hold any interests in the fund, and the general partner is not liable for any losses in the fund. Several employees of the general partner have interests in the fund. These employees chose to purchase interests in the fund and financed the purchases themselves.

55-205X The annual and performance-based fees paid to the general partner are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide those services
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.

Additionally, the general partner has no related parties with interests in the fund that individually, or in the aggregate, would absorb more than an insignificant amount of the fund's expected losses or receive more than an insignificant amount of the fund's expected residual returns. For purposes of this assessment, the general partner did not include its employees' interests in the fund because the general partner did not finance those interests; therefore, the general partner has neither a direct nor an indirect economic interest in the fund. The general partner's annual and performance-based fees do not represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38.

55-205Y On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the general partner does not have a variable interest in the fund. The general partner has no further consolidation analysis to perform.

>>> Case L: eCommerce Entity

55-205Z Company B, an affiliate of Company A, owns certain intellectual property related to eCommerce activities. Company A establishes a VIE to which Company A provides an exclusive services and asset licensing agreement. The VIE obtains access to the intellectual property owned by Company B. Company A agrees to provide strategic and technical services to the VIE and contracts with Company B to perform these services. Company B, Company A, and the VIE share the same senior management.

55-205AA Because of regulatory restrictions, Company A and its investors are precluded from owning equity in the VIE. The VIE is domiciled in a different country, which prohibits foreign investment through equity.

55-205AB The equity investors in the VIE, who are the senior management of Company A, have rights that are limited to only administrative matters.

55-205AC Company A's compensation for the services and asset licensing agreement is the net income of the VIE, but not the VIE's net losses. The fees paid to Company A are both of the following:

a. Compensation for services provided but not commensurate with the level of effort required to provide those services
b. Part of a service arrangement that does not include only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

55-205AD To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purpose for the creation of the VIE was to bypass foreign investment restrictions and enable foreign investors (through their ownership of Company A) to participate indirectly in restricted sectors in which Company B operates through a series of contractual arrangements.
b. Company A will receive all of the net income but none of the net losses of the VIE.
c. The equity investors, the senior management of Company A, are exposed to the net losses of the VIE through their equity investments.

55-205AE Company A and the equity investors of the VIE are the variable interest holders in the VIE. The fees paid to Company A represent a variable interest on the basis of consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(a) and (d).

55-205AF Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the performance of Company B. Company A, through its contractual arrangements, has the power to direct the activities that most significantly impact the VIE's economic performance.

55-205AG The equity investors of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE's economic performance.

55-205AH If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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. Company A, through its fee arrangements, receives benefits that could potentially be significant to the VIE. The fees paid to Company A are both of the following:

a. Compensation for services provided but not commensurate with the level of effort required to provide those services
b. Part of a service arrangement that does not include only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

Therefore, the fees do not meet the criteria in paragraph 810-10-25-38H, and they should be considered for purposes of paragraph 810-10-25-38A(b).

55-205AI On the basis of the specific facts and circumstances presented in this Case and the analysis performed, Company A would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.
b. Through fee arrangements, it has the right to receive benefits from the VIE that could potentially be significant to the VIE.

7. Consolidation and deconsolidation procedure

Detailed contents

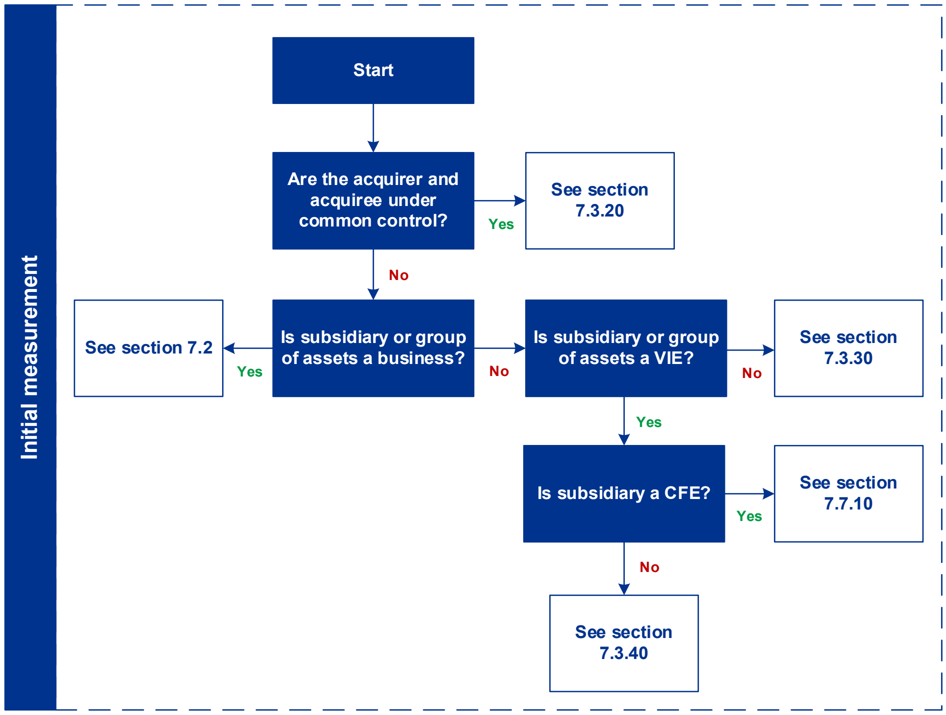
Item significantly updated in this edition: #

Examples

Questions

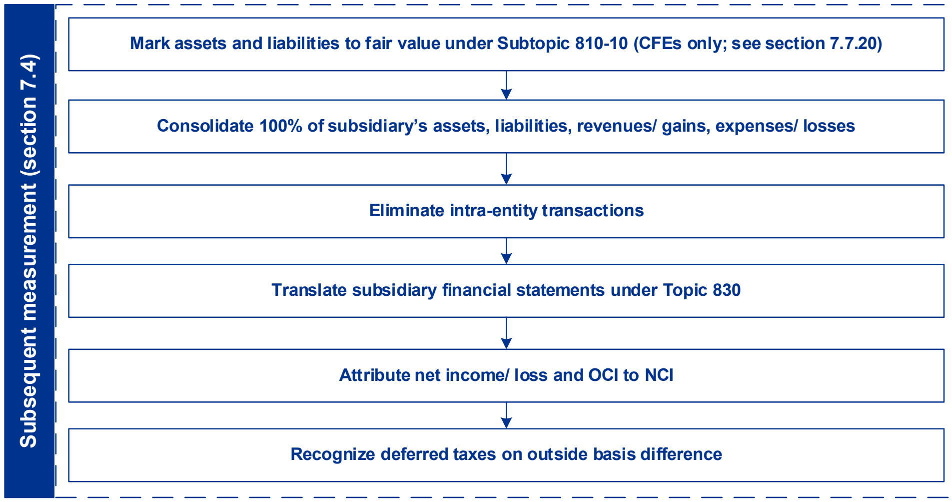
7.1 How the standard works

Consolidation and deconsolidation procedure can be broken into three distinct phases: initial measurement, subsequent measurement and accounting for changes in ownership.



In initial measurement, a key determination is whether the legal entity or group of assets being consolidated (the 'subsidiary') meets the definition of a business. If it does, the party with the controlling financial interest (the 'parent') applies the business combinations guidance in Topic 805. If not, it applies the asset acquisition guidance in Subtopic 805-50.

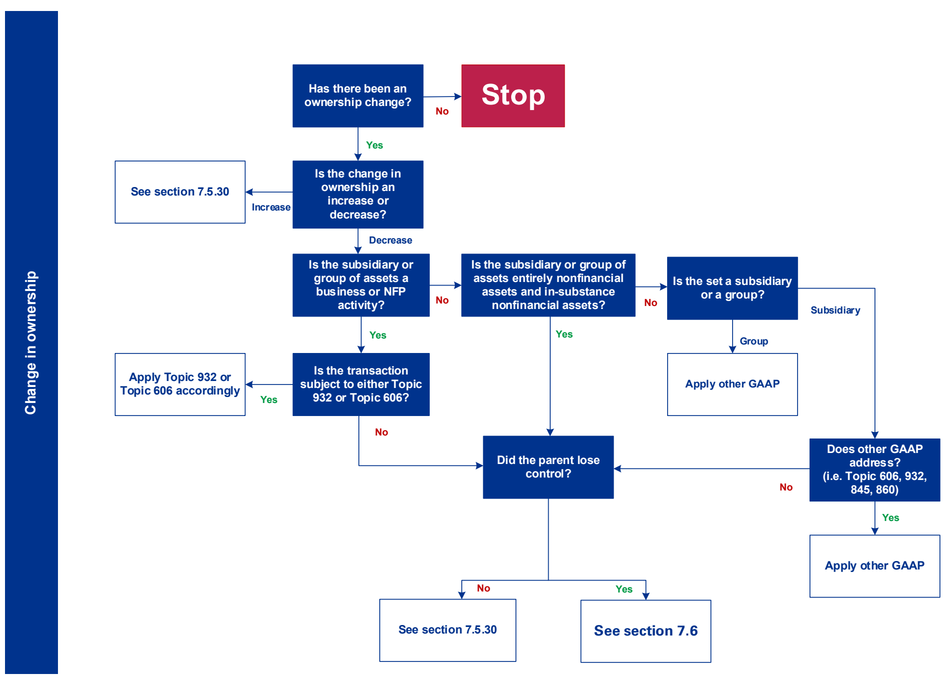
In subsequent measurement, the parent first consolidates the subsidiary's assets, liabilities and components of comprehensive income. It then considers Day 2 implications. The steps are as follows.



At any point after initial consolidation, changes in controlling or NCI holder's ownership may occur. A change in ownership that does not result in a change in control is accounted for as an equity transaction (unless other US GAAP applies). This includes when:

— the parent increases ownership; or
— the parent decreases ownership while retaining control.

When a parent does lose control, it deconsolidates the subsidiary – i.e. it derecognizes the assets, liabilities and equity components related to the subsidiary.



7.2 Initial measurement: Business combinations (excluding common control transactions)

Excerpt from ASC 805-10

25-1 An entity shall determine whether a transaction or other event is a **business combination** by applying the definition in this Subtopic, which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a **business**, the reporting entity shall account for the transaction or other event as an asset acquisition. An entity shall account for each business combination by applying the acquisition method.

> Identifying the Acquirer

25-4 For each business combination, one of the combining entities shall be identified as the acquirer.

25-5 The guidance in the General Subsections of Subtopic 810-10 related to determining the existence of a controlling financial interest shall be used to identify the acquirer—the entity that obtains **control** of the **acquiree**. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 805-10-55-11 through 55-15 shall be considered in making that determination. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of Subtopic 810-10, not by applying either the guidance in the General Subsections of that Subtopic, relating to a controlling financial interest, or in paragraphs 805-10-55-11 through 55-15.

> Identifying the Acquisition Date

25-6 The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

25-7 The date on which the acquirer obtains control of the acquiree generally is the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquire the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

> Particular Types of Business Combinations

>> A Business Combination Achieved in Stages

25-10 In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date **fair value** and recognize the resulting gain or loss, if any, in earnings. In prior reporting periods, with respect to its previously held equity method investment, the acquirer may have recognized amounts in other comprehensive income in accordance with paragraph 323-10-35-18. If so, the amount that was recognized in other comprehensive income shall be reclassified and included in the calculation of gain or loss as of the acquisition date. If the business combination achieved in stages relates to a previously held equity method investment that is a **foreign entity**, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

>> A Business Combination Achieved Without the Transfer of Consideration

25-11 An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include any of the following:

a. The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.
b. Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting interest.
c. The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no **equity interests** in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual-listed corporation.

25-12 In a business combination achieved by contract alone, the acquirer shall attribute to the equity holders of the acquiree the amount of the acquiree's net assets recognized in accordance with the requirements of this Topic. In other words, the equity interests in the acquiree held by parties other than the acquirer are a **noncontrolling interest** in the acquirer's postcombination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the noncontrolling interest.

Excerpt from ASC 805-20

> Recognition Principle

25-1 As of the **acquisition date**, the **acquirer** shall recognize, separately from **goodwill**, the **identifiable** assets acquired, the liabilities assumed, and any **noncontrolling interest** in the **acquiree**. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 805-20-25-2 through 25-3. However, an entity (the acquirer) within the scope of paragraph 805-20-15-2 may elect to apply the accounting alternative for the recognition of identifiable intangible assets acquired in a business combination as described in paragraphs 805-20-25-29 through 25-33.

>> Recognition Conditions

25-2 To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements, at the acquisition date. For example, costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its postcombination financial statements in accordance with other applicable generally accepted accounting principles (GAAP).

25-3 In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the **business combination** transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 805-10-25-20 through 25-23 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable GAAP.

25-4 The acquirer's application of the recognition principle and conditions may result in recognizing some assets and liabilities that the acquiree had not previously recognized as assets and liabilities in its financial statements. For example, the acquirer recognizes the acquired identifiable **intangible assets**, such as a brand name, a patent, or a customer relationship, that the acquiree did not recognize as assets in its financial statements because it developed them internally and charged the related costs to expense.

25-5 Paragraphs 805-20-25-11 through 25-12 provide guidance on recognizing operating leases and paragraphs 805-20-55-2 through 55-45 provide guidance on recognizing intangible assets. Paragraphs 805-20-25-17 through 25-28B specify the types of identifiable assets and liabilities that include items for which this Subtopic and Subtopic 805-740 provide limited exceptions to the recognition principle and conditions in paragraphs 805-20-25-1 through 25-3.

>> Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in a Business Combination

25-6 At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.

> Measurement Principle

30-1 The **acquirer** shall measure the **identifiable** assets acquired, the liabilities assumed, and any **noncontrolling interest** in the **acquiree** at their **acquisition-date fair values**.

Excerpt from ASC 805-30

> Measurement of Goodwill

30-1 The **acquirer** shall recognize **goodwill** as of the **acquisition date**, measured as the excess of (a) over (b):

a. The aggregate of the following:
   1. The consideration transferred measured in accordance with this Section, which generally requires acquisition-date **fair value** (see paragraph 805-30-30-7)
   2. The fair value of any **noncontrolling interest** in the **acquiree**
   3. In a **business combination** achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b. The net of the acquisition-date amounts of the **identifiable** assets acquired and the liabilities assumed measured in accordance with this Topic.

Excerpt from ASC 810-10

Variable Interest Entities

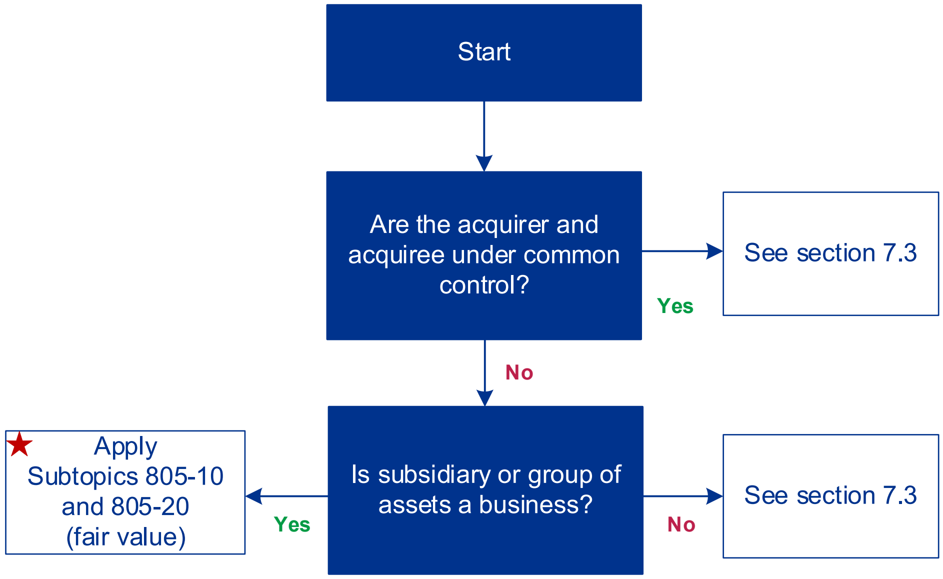
> Valuation of Assets, Liabilities, and Noncontrolling Interests in a Newly Consolidated VIE

>> Entities Not under Common Control

30-2 The initial consolidation of a VIE that is a **business** is a **business combination** and shall be accounted for in accordance with the provisions in Topic 805.

7.2.10 Overview

Initial measurement on consolidation depends on whether the legal entity or group of assets being consolidated (the 'subsidiary') is under common control with the parent and if not, whether it meets the definition of a business as shown in the following diagram. This section discusses initial measurement if the subsidiary is a business.



Topic 805 requires the assets, liabilities and NCI to be initially measured using the acquisition method when they are acquired in a business combination. This applies to any subsidiary (VOE or VIE) that is a business. [805-20-25-1, 30-1, 810-10-30-2]

Business combination	All transactions or events in which an enterprise obtains control of a business. This is regardless of whether or not control is obtained through the transfer of consideration.

There are exceptions to this initial measurement guidance when:

— the parent and the subsidiary are under common control (see section 7.3); and

— the acquiring enterprise transferred assets and/or liabilities to the subsidiary upon (or shortly before) becoming the parent (see Question 7.2.80).

Question 7.2.10

What are the key steps in applying the acquisition model under Topic 805?

Interpretive response: The following are key steps in applying the acquisition model.

Determine acquirer	There is only one acquirer in every business combination. The acquirer is the entity that obtains control over the business. In business combinations involving more than two entities, determining the acquirer includes consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities. [805-10-25-4] The guidance in Subtopic 810-10 is used to determine the acquirer. If applying that guidance does not clearly indicate

	which of the combining entities is the acquirer, the factors in Topic 805 are considered in making the determination. The acquirer in a business combination in which a VIE is acquired is always the primary beneficiary of the VIE. [805-10-25-5]
Determine the acquisition date	The acquisition date is the date on which the acquirer obtains control of the acquiree. On the acquisition date, the acquirer accounts for the business combination by applying the acquisition method. [805-10-25-6 – 25-7] In a step acquisition, an entity (the acquirer) acquires shares of another entity (the investee) in two or more transactions in which the acquirer ultimately gains control of the investee. On the date the acquirer obtains control over the acquiree, a business combination has occurred and the acquirer accounts for the combination by the acquisition method on that date. [805-10-25-10]
Recognize acquired items	An acquirer is required to recognize and measure the following at their acquisition-date fair values (with limited exceptions) separately from goodwill: [805-20-25-1, 30-1] — identifiable assets acquired; — liabilities assumed; and — any NCI in the acquiree – i.e. the portion of the equity of a subsidiary that is not owned by the parent. Goodwill is measured as a residual amount.

See KPMG Handbook, Business combinations, for interpretive guidance on accounting for business combinations.

7.2.20 Determine when a business combination occurs

Question 7.2.20

When does a parent consolidate a subsidiary that is a business?

Interpretive response: A parent consolidates a subsidiary that is a business when it obtains a controlling financial interest in that subsidiary (see Question 7.2.10). Obtaining a controlling financial interest is a point-in-time evaluation (see Question 7.2.60). Therefore, when an enterprise obtains a controlling financial interest in a business, a business combination has occurred, and the transaction is in the scope of Topic 805.

A controlling financial interest may be obtained in stages through a series of transactions. A parent consolidates a subsidiary that is a business on the date it gains a controlling financial interest in the subsidiary. At that date, the parent applies the acquisition method to account for the combination. [805-10-25-10]

See chapter 5 of KPMG Handbook, Business combinations, for a discussion on determining the acquisition date.

Question 7.2.30

Can an enterprise have a controlling financial interest through temporary control of a legal entity?

Interpretive response: Yes. There is no concept of temporary control that allows for an exception from the scope of Topic 805. Therefore, a parent consolidates a subsidiary that is a business when it obtains a controlling financial interest in that subsidiary (see Question 7.2.10).

However, temporary control could indicate that the parent does not have a controlling financial interest. Careful consideration should be given to contractual terms that accompany transactions that transfer temporary control to determine if the party being granted temporary control does not obtain a controlling financial interest. For example, such terms may grant the NCI holder(s) substantive participating rights, which may prevent the acquirer from having a controlling financial interest (see section 5.3).

Question 7.2.40

Does the manner of obtaining a controlling financial interest affect whether a business combination has occurred?

Interpretive response: No. The structure of a transaction or event does not affect the determination of whether a business combination has occurred. Instead, as the definition suggests, obtaining a controlling financial interest in one or more businesses by an acquirer is the determining factor.

Examples of ways a business combination may be structured for legal, tax or other reasons include the following (not exhaustive): [805-10-55-3]

— one or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer;

— one combining entity transfers its net assets or its owners transfer their equity interests to another combining entity or its owners;

— all of the combining entities transfer their net assets or the owners of those entities transfer their equity interests to a newly formed entity – sometimes referred to as a roll-up or put-together transaction;

— a group of former owners of one of the combining entities obtains a controlling financial interest in the combined entity.

See chapter 2 of KPMG Handbook, Business combinations, for a discussion on identifying a business combination.

Question 7.2.50

Can a business combination occur when no consideration has been transferred?

Interpretive response: Yes. A business combination is a transaction or event in which an enterprise obtains a controlling financial interest in one or more businesses. Topic 805 indicates that a parent-subsidiary relationship can be achieved by contract alone. [810-10-15-8, 805-10-25-11]

The following circumstances illustrate how an acquirer might obtain a controlling financial interest in an acquiree without transferring consideration: [805-10-25-11]

— the acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control;

— minority substantive participating rights lapse that previously kept the acquirer from controlling an acquiree when the acquirer held the majority voting interest;

— the acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously.

Many business combinations achieved by contract alone result in the formation of a VIE. In these situations, the primary beneficiary of the VIE is always the acquirer, because the acquiree's equity-at-risk investors lack the power to direct the activities that most significantly impact the VIE's economic performance (see section 4.4).

See chapter 2 of KPMG Handbook, Business combinations, for a discussion on identifying a business combination.

Example 7.2.10

Initial consolidation of a VIE that is a business

Background

Enterprise is involved with Legal Entity. Legal Entity is both a VIE and a business.

In Year 1, at the time of its initial involvement with Legal Entity, Enterprise determined that it was not the primary beneficiary of Legal Entity and therefore did not consolidate Legal Entity.

On July 1, Year 3, the governing documents and contractual arrangements among the parties involved with Legal Entity are revised and give Enterprise the power to direct the activities that most significantly impact Legal Entity's economic performance.

Evaluation

On July 1, Year 3, Enterprise concludes that it is the primary beneficiary of Legal Entity.

This event is a business combination under Topic 805. On July 1, Year 3, Enterprise applies the acquisition method by:

— remeasuring its previously held interest in Legal Entity to its acquisition-date fair value and recognizing any resulting gain or loss in net income (see Question 7.2.90);

— recognizing and measuring 100% of the identified assets acquired, the liabilities assumed, and NCI under the principles of Topic 805 (see Question 7.2.80); and

— recognizing and measuring goodwill (or a bargain purchase gain).

Question 7.2.10 provides guidance on the key steps in applying the acquisition model.

Question 7.2.60

Should multiple transactions be considered a single transaction when evaluating if a controlling financial interest has been obtained?

Interpretive response: An enterprise may enter into multiple transactions to obtain a controlling financial interest in a business. The following are examples.

— An enterprise initially purchases 30% of a business and then shortly thereafter purchases an additional 25% to gain control.

— An enterprise negotiates the acquisition of a business in aggregate but consummates the acquisition by entering into separate legal agreements with each business subsidiary.

— Assets and processes are acquired over time that do not meet the definition of a business on an individual basis but would constitute a business if evaluated together.

We believe the following factors listed in paragraph 810-10-40-6 (related to deconsolidation) may be considered to determine whether multiple transactions should be accounted for as a single transaction:

— they are entered into at the same time or in contemplation of one another;
— they form a single transaction designed to achieve an overall commercial effect;
— the occurrence of one arrangement depends on the occurrence of at least one other arrangement;
— one arrangement considered on its own is not economically justified, but they are economically justified when considered together.

If an enterprise determines that each transaction should be accounted for separately, assets acquired and liabilities assumed would be evaluated and accounted for separately under applicable US GAAP. Alternatively, if an enterprise determines that multiple transactions should be accounted for as a single transaction, those transactions would be evaluated and accounted on a combined basis under applicable US GAAP.

Acquisition by a parent of some or all of the NCI in a subsidiary is not a business combination, because a controlling financial interest is not obtained as a result of the transaction – the parent had a controlling financial interest in the subsidiary before the transaction. This would be accounted for as an equity transaction. See section 7.5.30.

See chapter 2 of KPMG Handbook, Business combinations, for a discussion on identifying a business combination.

Question 7.2.70

How does an enterprise determine if it is the acquirer or the acquiree in a business combination?

Interpretive response: Identifying the acquirer (parent) in a business combination is typically straightforward; the acquirer is the enterprise that obtains a controlling financial interest in the other enterprise(s) in the combination transaction. When the combination transaction involves transferring cash or other assets (or incurring liabilities), the acquirer is usually the enterprise that makes the transfer. When the combination involves an exchange of equity interests, the acquirer is usually the enterprise that issues its equity interests. [805-10-25-5, 55-10 – 55-12]

However, sometimes it is unclear which enterprise has the controlling financial interest after considering the guidance in Subtopic 810-10. In that case, Topic 805 requires that other facts and circumstances be considered in making the determination, including the factors described in paragraphs 805-10-55-11 to 55-15. No individual factor is necessarily determinative. Instead, all relevant facts and circumstances should be considered in determining which of the combining enterprises is the acquirer. [805-10-25-5, 55-10 – 55-15]

As an exception to the requirement to consider other facts and circumstances when determining the accounting acquirer, when the legal acquiree is a VIE, the primary beneficiary of the VIE is the accounting acquirer. [805-10-25-5]

See chapter 4 of KPMG Handbook, Business combinations, for a discussion on identifying the acquirer in a business combination.

7.2.30 Initially measure assets, liabilities and NCI

Question 7.2.80

How does a parent initially measure the assets, liabilities and NCI when it consolidates a subsidiary that is a business?

Interpretive response: As discussed in Question 7.2.10, the acquirer in a business combination generally recognizes and measures the assets acquired, liabilities assumed and any NCI at their acquisition-date fair values. Goodwill (or bargain purchase gain) is measured as the residual amount. [805-20-25-1, 30-1]

However, there are exceptions to the measurement principle, which include: [805-20-30-10 – 30-26]

- income taxes;
- employee benefits;
- indemnification assets;
- required rights;
- share-based payment awards;
- assets held-for-sale;
- certain assets and liabilities arising from contingencies;
- leases;
- purchased financial assets with credit deterioration (after application of Topic 326 (credit losses)); and
- contract assets and contract liabilities (after adoption of ASU 2021-08)

Further, a parent measures assets or liabilities of the subsidiary at their carryover bases (i.e. the assets or liabilities are not measured at fair value) when the parent: [805-30-30-8, 810-10-30-3]

- transfers those assets or liabilities as consideration for the business combination and they remain in the combined financial statements after the transaction; or
- transfers those assets or liabilities to the subsidiary at, or shortly before, the business combination and the subsidiary is a VIE.

In both of these situations, the parent recognizes no gain or loss on the transfer.

See chapter 6 of KPMG Handbook, Business combinations, for a discussion on recognizing and measuring the consideration transferred in a business combination, and chapter 7 for a discussion on recognizing the identifiable assets acquired, liabilities assumed and NCI.

Question 7.2.90

How does an investor transition from the equity method to consolidation when it obtains a controlling financial interest in a business?

Interpretive response: When an equity method investor increases its ownership (or its influence) to a level at which it obtains a controlling financial interest in an equity method investee, it stops applying the equity method.

The investor remeasures in net income its previously held equity method interest to its acquisition-date fair value and reclassifies the related CTA, if any, from AOCI, if: [805-10-25-10]

- the investor and seller are not under common control (see section 7.3); and
- the investee is a business.

After the investor remeasures its existing interest, it initially measures at fair value the newly acquired assets, liabilities and NCI under Topic 805 and Topic 810.

When an investor remeasures its investment, the remeasurement generally results in an additional deferred tax liability because it creates or increases a taxable outside basis difference in the investment. Further, there may be implications for previously recognized deferred tax liabilities and deferred tax assets. This is because there are exceptions to recognizing deferred tax assets and liabilities related to outside basis differences in subsidiaries that do not apply to equity method investments. For additional guidance, see Question 6.2.60 of KPMG Handbook, Equity method of accounting, and section 6 of KPMG Handbook, Accounting for income taxes.

Question 7.2.100

How does an investor transition from the measurement alternative to consolidation when it obtains a controlling financial interest?

Background: Topic 321 requires an investor with an in-scope equity investment to measure it at fair value through net income. However, an investor may choose to measure an equity investment that does not have a readily determinable fair value using a measurement alternative. The measurement alternative allows the investor to measure the equity investment at cost minus any impairment, plus or minus value changes based on observable prices in orderly transactions for the identical or similar investment of the same issuer.

For additional guidance, see chapter 5 of KPMG Handbook, Investments.

Interpretive response: If an investor increases its ownership to a level at which it obtains a controlling financial interest in a business, it remeasures in net income its previously held equity interest in the acquiree at its acquisition-date fair value. [805-10-25-10]

Question 7.2.110

How does an investor transition from accounting for its investment at fair value through OCI to consolidation when it obtains a controlling financial interest?

Interpretive response: If an investor increases its ownership to a level at which it obtains a controlling financial interest in a business, the unrealized gain or loss accumulated through the acquisition date that was previously recognized in AOCI is reclassified to net income. For example, this may arise when the previously held interest was classified as an available-for-sale debt security. [805-10-25-10]

7.2.40 Recognize and measure NCI

Question 7.2.120

What is the framework for determining classification at initial recognition of an NCI with redemption features?

Background: NCI with redemption features may arise in a number of ways, for a variety of purposes, and with widely varying terms. Redemption features may be embedded in the NCI holder's shares when those shares were originally issued, or they may arise at a later date (e.g. in connection with the business combination).

Redemption rights may take the form of a put option held by the NCI holder or may be a combination of puts and calls. The strike price of the redemption feature may be a fixed amount, it may equal the fair value of the underlying NCI shares, or it may vary based on a formula or other factors.

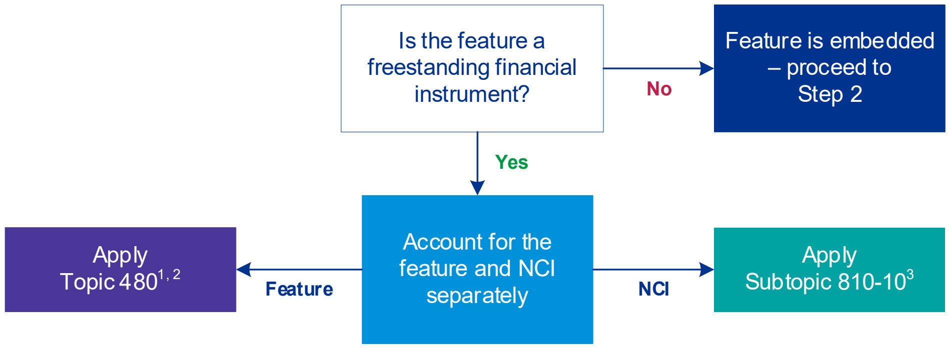
Sometimes the intent of a redemption feature is to facilitate delivery of all of the shares to the parent at a later date (i.e. a financing or delayed delivery mechanism) for liquidity, tax or other reasons. Other times, the redemption features represent a protective right granted to the NCI holder(s) and/or a method for the parent to limit transferability of the NCI (by requiring that any sale of NCI be to the parent or the subsidiary).

Interpretive response: The general framework for classifying NCI with redemption features is summarized in the five-step process described below.

- Steps 1 to 4 address whether NCI with redemption features should be classified as liabilities or equity and provide a high-level overview of existing guidance in Topic 480 (distinguishing liabilities from equity) and Topic 815 (derivatives and hedging).
- Step 5 discusses the application of Section 480-10-S99 and related guidance to redeemable NCI that are not classified as liabilities.

Step 1: Evaluate whether the redemption feature is a freestanding financial instrument or is embedded in the NCI shares

Step 1 is summarized in the following decision tree.



Notes:

1. The feature is accounted for as a liability. [480-10-25-8, 25-10, 25-12]
2. Physically settled forward contracts to purchase a fixed number of the issuer's equity shares in exchange for cash are measured at the present value of the amount to be paid at settlement. Those contracts are not considered derivative instruments when applying Topic 815. [480-10-35-3, 815-10-15-74(d)]
3. The accounting for the underlying NCI is not affected by the freestanding redemption feature.

Determining whether a feature is freestanding or embedded may require significant judgment. A parent should document its analysis and the rationale for its conclusion. See chapter 9 of KPMG Handbook, Debt and equity financing, for guidance on how to evaluate whether a feature is freestanding or embedded.

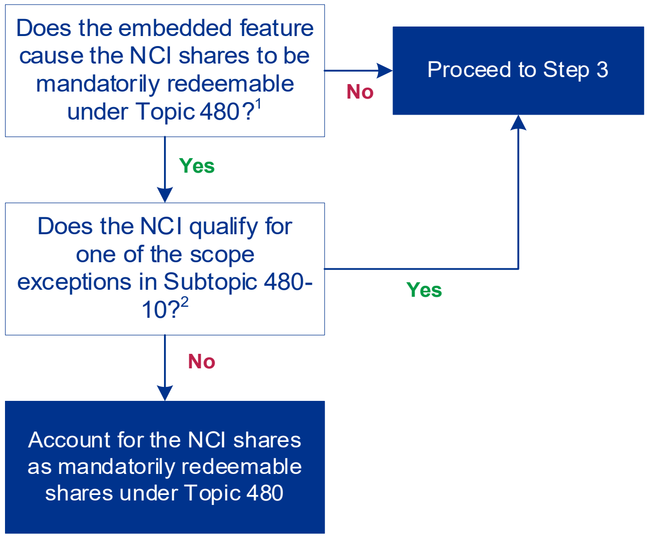
A freestanding instrument is classified as a liability (or an asset in some circumstances) under Topic 480 if it embodies an obligation to redeem NCI and requires the issuer to satisfy the obligation by transferring assets. Those instruments are measured at fair value each period with changes in fair value reported in net income. [480-10-25-8, 25-10, 25-12]

Some of those freestanding instruments are also in the scope of Topic 815. Although the parent measures a freestanding feature to redeem NCI the same way under Topic 480 and Topic 815, it must determine if the instrument is a derivative because if it is, it is:

— subject to the disclosure requirements of Topic 815; and
— eligible to be designated as a hedging instrument if the parent elects to do so.

Step 2: Evaluate whether NCI are mandatorily redeemable financial instruments in the scope of Topic 480

If a redeemable feature is embedded in NCI, the parent must determine whether the embedded feature causes the NCI shares to be mandatorily redeemable financial instruments. This step is summarized in the following decision tree. [480-10-25-4, 25-6]



Notes:

1. An instrument issued in the form of a share is a mandatorily redeemable financial instrument if it embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date(s) or upon an event that is certain to occur. Parents classify mandatorily redeemable instruments as liabilities unless a scope exception is applicable (see note 2).
2. Subtopic 480-10 includes three scope exceptions to the mandatorily redeemable financial instruments guidance. Under these exceptions, an instrument may meet the criteria to be accounted for as a mandatorily redeemable financial instrument but is exempt from one or more of the provisions of Topic 480.
   - instruments that are mandatorily redeemable only upon the liquidation or termination of the reporting entity; this scope exception applies to all entities, including SEC registrants [480-10-25-4, 25-6]
   - mandatorily redeemable NCI that are required to be redeemed only on liquidation or termination of the consolidated subsidiary that issued those instruments or other mandatorily redeemable NCI that were issued before November 5, 2003; this scope exception applies to all entities, including SEC registrants [480-10-15-7E]
   - mandatorily redeemable financial instruments issued by non-SEC registrants that are not redeemable on fixed dates for amounts that are fixed or determined by reference to specified indices. [480-10-15-7A]

See section 6.4 of KPMG Handbook, Debt and equity financing, for a discussion on how to evaluate whether a share is a mandatorily redeemable financial instrument, and whether a scope exception in Subtopic 480-10 applies.

Step 3: Evaluate whether the NCI should be accounted for as debt obligations

If a parent concludes in Step 3 that NCI with embedded put and call options are subject to the guidance in paragraphs 480-10-55-53 to 55-63, the NCI is accounted for as a debt obligation under that guidance. In contrast, if the entity concludes that such NCI shares are not subject to the guidance in those paragraphs, it proceeds to Step 4.

Paragraphs 480-10-55-53 to 55-63 pertain to derivatives indexed to the minority interest in a business combination. Specifically, these paragraphs apply to transactions in which a controlling interest is obtained (or NCI are issued) and the NCI contain embedded put and call options with the following terms:

— the parent (or the subsidiary) has a call option to purchase the NCI at a fixed price at a stated future date; and
— the NCI holder has a put option to sell the NCI to the parent (or the subsidiary) under those same terms.

The embedded put and call options in this circumstance are viewed on a combined basis with the NCI and accounted for as a debt obligation. [480-10-55-53 – 55-63]

Even if the embedded put and call options do not have a fixed strike price or are not exercisable at a stated future date, it may still be appropriate for the NCI to be classified as a debt obligation in their entirety based on the guidance in paragraphs 480-10-55-53 to 55-63. However, such a classification is not appropriate if the puts and calls are exercisable for a strike price equal to the then-current fair value of the underlying NCI shares. Judgment is required when evaluating whether the substance of the arrangement is a debt obligation, and all relevant facts and circumstances should be considered in making that determination.

Step 4: Evaluate whether the embedded redemption feature should be separated from the NCI and accounted for as a derivative under Topic 815

Step 4 requires that a parent evaluate whether an embedded redemption feature should be separated from its host contract and accounted for as a derivative under Topic 815. Regardless of whether the embedded redemption feature is required to be separately accounted for as a derivative, the analysis should proceed to Step 5. [815-15-25-1]

Step 5: Apply Section 480-10-S99 and related guidance

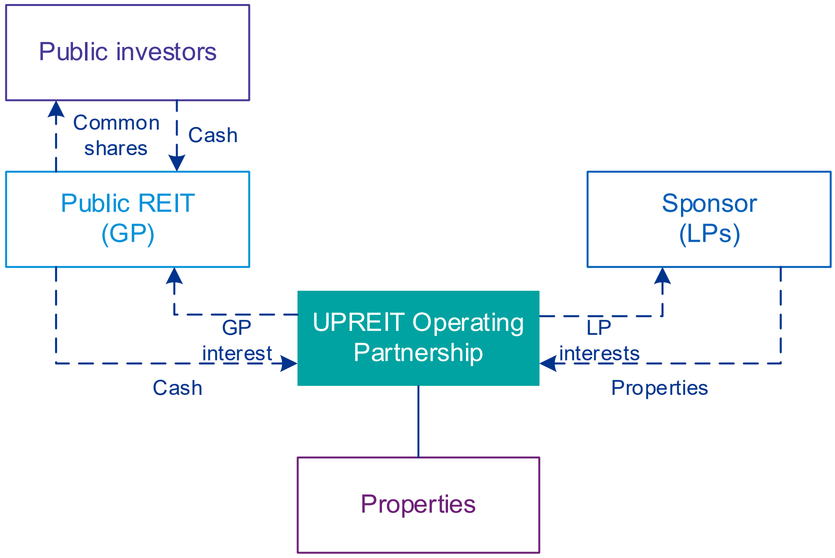
Section 480-10-S99 reproduces the SEC guidance in Accounting Series Release No. 268. That guidance applies to redeemable NCI that is not classified as a liability. See section 8.2.20 for information on this step.

Question 7.2.130

How does the guidance on NCI with redemption features apply to UPREITs?

Background: Publicly traded REITs often employ a structure referred to as an umbrella partnership real estate investment trust (UPREIT). In a typical UPREIT transaction, an operating partnership is formed by a sponsor. The sponsor and/or its related entities contribute real estate properties and related debt to the operating partnership (OP) in exchange for an LP interest in the OP.

At the formation of the OP, a REIT invests proceeds from a public offering in exchange for a controlling (GP) interest in the operating partnership. The sponsor retains an NCI in the OP. Because of its controlling financial interest, the REIT consolidates the operating partnership in its financial statements.



In a typical UPREIT structure, the publicly traded REIT is the sole GP of the operating partnership and generally holds the majority of the LP interests of the operating partnership. The REIT generally has few or no assets, liabilities or operations other than its interest in the operating partnership. Further, the REIT and the operating partnership generally share the same executive officers.

The REIT's GP and LP interests in the operating partnership entitle the REIT to share in cash distributions from, and in the profits and losses of, the operating partnership in proportion to its percentage interest. The REIT's interests also entitle it to vote on all matters requiring a vote of the LPs. The operating partnership units generally receive distributions on the same basis as the dividends received by the REIT shareholders.

When an UPREIT operating partnership purchases real estate properties after its formation, it often gives the sellers common units in the operating partnership as consideration for the assets. Such transactions generally do not trigger a taxable gain for the sellers until the operating units are exchanged for shares of the REIT (as described below) or sold.

NCI redemption right

The NCI holder(s) in the operating partnership (which include the sponsor and subsequent sellers of real estate properties to the operating partnership) have the right to redeem their interests for an amount per unit that equals the market value of a share of the REIT's common stock. A sponsor's ability to exercise this redemption right generally begins only after a negotiated lock-out period after formation of the UPREIT structure.

The NCI holder(s) are not required to exercise their redemption rights at any time. However, if an NCI holder exercises its redemption right, the REIT can satisfy the redemption request by delivering one REIT share for each operating partnership unit that is redeemed. If REIT shares are not delivered, either the operating partnership or the REIT (depending on the terms of the operating partnership agreement and other related agreements) is required to satisfy the redemption in cash (or other assets) with an equivalent value to those shares.

Redemption fulfilled by the REIT

The REIT generally has no assets other than its interest in the operating partnership and therefore obtains the cash to satisfy a cash redemption obligation through an intercompany transfer from the operating partnership. Therefore, the accounting guidance on redeemable NCI applies even if the related agreements specify that a cash redemption payment would be made by the REIT, instead of by the operating partnership.

Other redeemable units

Certain operating partnerships may also issue preferred units to third parties that can be exchanged for preferred shares of the REIT in the same manner as common LP interests. The guidance described below on redeemable NCI applies to both common and preferred units of an operating partnership.

REIT ownership interest

Common and preferred units of an operating partnership that are held by the REIT (the controlling interest holder) are not generally subject to redemption.

Interpretive response: The consolidated financial statements of REITs and other real estate entities often involve NCI that is subject to contractual redemption features – e.g. NCI that is subject to put-call arrangements and puttable units issued by an operating partnership.

The REIT considers the guidance in Topic 815, Topic 480, and Section 480-10-55 when accounting for a redeemable NCI.

If both…	— the redeemable NCI is not accounted for as a liability in its entirety under Topic 480; and — the redemption feature is not separately accounted for as a liability under Topic 815 (derivatives and hedging),
Then…	Evaluate whether the NCI must be classified as temporary equity under Section 480-10-S99.

The following is a summary of the guidance on temporary-equity presentation.

Preferred securities redeemable for cash or other assets are **classified outside of permanent equity** in the balance sheet of an SEC registrant if they are either…	— redeemable at a fixed or determinable price on a fixed or determinable date at the option of the holder; or — redeemable on the occurrence of an event that is not solely within the control of the issuer (see section 8.2.20).
Similar guidance applies to redeemable equity instruments other than preferred shares provided those instruments are **not classified as liabilities** under Topic 480 or other applicable US GAAP, such as… [480-10-S99]	— common shares — NCI — share-based payment arrangements — certain other equity-related contracts

See Question 7.2.120 on determining whether the NCI or the redemption feature must be accounted for as a liability, and section 8.2.20 on applying the temporary equity guidance.

See also section 7.5.20 on the subsequent measurement of redeemable NCI.

Question 7.2.140
How is redeemable NCI initially measured?

Interpretive response: A parent measures a redeemable NCI at fair value at the date it initially consolidates the subsidiary (see Question 7.2.80). [480-10-S99, 805-20-30-1]

If the equity instrument is issued later in a transaction in which the parent is reducing its ownership interest but retains control, it is generally measured based on the NCI holder's post-transaction interest in the subsidiary's post-transaction book value (see Question 7.5.160). [480-10-S99, 810-10-45-23]

We believe this guidance applies to all parent companies – i.e. including those that are not subject to SEC reporting and do not choose to present these instruments in temporary equity (see Question 8.2.60).

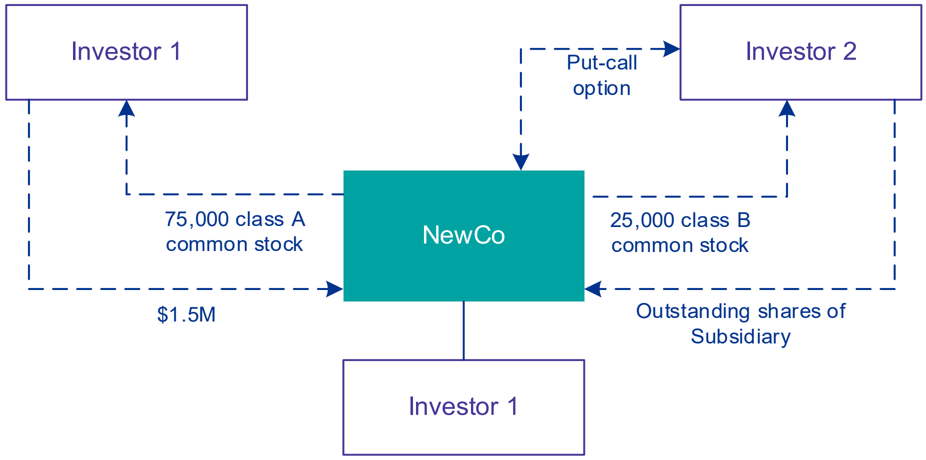
Example 7.2.20
Purchase of a controlling financial interest – redeemable NCI

Background

Investor1 (acquirer) purchases 75% of Subsidiary from Investor2 (seller) for $1.5 million on January 1, Year 1. The transaction is structured as follows:

— Investor2 transfers all of the outstanding shares of Subsidiary to a newly formed entity (NewCo) in exchange for 25,000 Class B common shares; and

— Investor1 transfers $1.5 million to NewCo in exchange for 75,000 Class A common shares.



The Class A and B shares are identical in all respects, except that the terms of the Class B shares provide the following put-call option:

— Put option: Investor2 has the ability to require NewCo to purchase its Class B shares on the seventh anniversary after the acquisition date.
— Call option: NewCo has the right to purchase its Class B shares from Investor2 at any time after the fifth anniversary of the acquisition date.

Scenario 1: Formula-based strike price

The embedded put and call options have the same strike price, which is derived by applying a fixed multiple to Subsidiary's trailing EBITDA. The redemption formula is not at fair value or designed to equal or reasonably approximate fair value.

At January 1, Year 1, the fair value of the redeemable NCI is $450,000.

On January 1, Year 1, Investor1 measures the Class B shares at their acquisition-date fair value ($450,000) and classifies them in temporary equity.

The $20 price per unit paid by Investor1 in the acquisition ($1.5 million ÷ 75,000 Class A shares) differs from the $18 fair value per unit of the NCI ($450,000 ÷ 25,000 Class B shares) because:

— Investor1 paid a control premium; and
— the NCI includes the embedded put-call feature.

See Example 7.5.60 for subsequent measurement under this scenario.

Scenario 2: Fair value strike price

The put and call options have the same strike price, which is the fair value of the underlying shares at the redemption date. At January 1, Year 1, the fair value of the redeemable NCI is $450,000.

On January 1, Year 1, Investor1 measures the Class B shares at their acquisition-date fair value ($450,000) and classifies them in temporary equity.

The $20 price per unit paid by Investor1 in the acquisition ($1.5 million ÷ 75,000 Class A shares) differs from the $18 fair value per unit of the NCI ($450,000 ÷ 25,000 Class B shares) because Investor1 paid a control premium.

See Example 7.5.70 for subsequent measurement under this scenario.

Example 7.2.30
Purchase of a controlling financial interest – redeemable NCI based on a fixed redemption amount plus accumulated unpaid dividends

Background

On January 1, Year 1, Enterprise purchases 1,000 shares of Legal Entity's preferred stock for $603,000 ($603 per share), representing 50% of Legal Entity's total preferred shares outstanding.

The preferred shares have the following attributes:

— an aggregate stated value of $1 million ($1,000 per share);

— cumulative dividends payable at a rate of 8%, payable semi-annually;

— an embedded put option that provides the holder with the ability to sell the shares back to Legal Entity at any time after December 31, Year 9 (nine years from the date of issuance) for an amount equal to the stated value of the shares plus accumulated, unpaid dividends; and

— no mandatory redemption date.

Legal Entity presents the redeemable preferred shares as temporary equity (see Question 8.2.10). Enterprise accounts for the preferred shares as available-for-sale debt securities under Subtopic 326-30.

Years 1 – 4, dividends accumulate

From January 1, Year 1 through December 31, Year 4, Legal Entity does not declare any dividends on the preferred shares (i.e. the dividends accumulate as an increase to the redemption amount).

The fair value of the shares declines during this period to $797,000 as of December 31, Year 4 as a result of changes in market interest rates. The decline in fair value is not the result of deterioration in the issuer's creditworthiness.

Enterprise does not intend to sell the shares, and it is not likely it will be required to sell the shares before it recovers their basis.

To account for these events during Years 1 – 4, Enterprise recognizes:

— $357,000 of dividend income in net income based on the implied effective yield at inception of 12%;

— $163,000 of unrealized losses on the shares in AOCI as of December 31, Year 4 based on the difference between the shares' then fair value ($797,000) and accreted value determined using the 12% implied effective yield ($960,000).

The calculations of the accreted value and dividend income in this example assume that:

— the shares will be put back to Legal Entity on December 31, Year 9 (the earliest redemption date); and

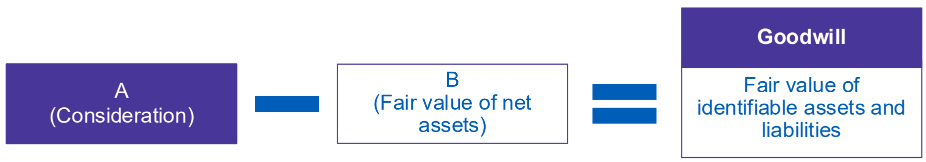
— the cumulative preferred stock dividends will be paid upon redemption – i.e. they will not be declared and paid before the redemption date.

Year 5, business combination occurs

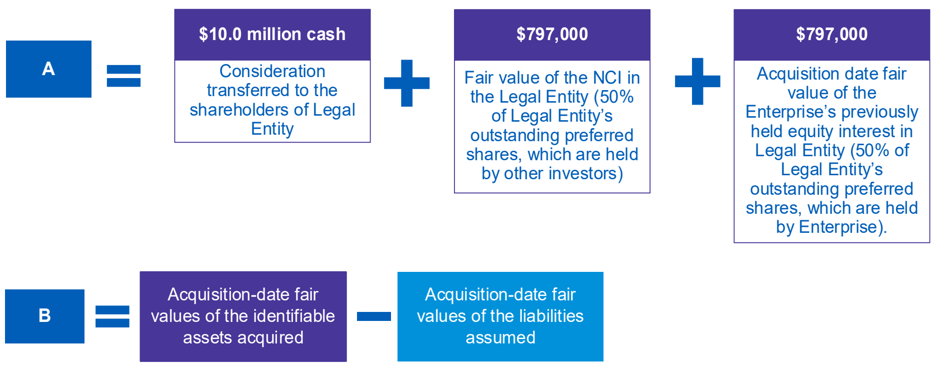
On January 1, Year 5, Enterprise acquires 100% of Legal Entity's outstanding common stock for $10 million cash. The 100% ownership represents a controlling financial interest in Legal Entity and Enterprise accounts for the acquisition as a business combination.

Evaluation

Under the acquisition method, the amount of goodwill from Enterprise’s acquisition of Legal Entity on January 1, Year 1 is measured as follows.



A and B are calculated as follows.



Enterprise initially measures the NCI in the business combination – i.e. 50% of Legal Entity’s outstanding preferred shares, which are held by other investors – at its acquisition-date fair value of $797,000 (see Question 7.2.140).

Enterprise also reclassifies from AOCI to net income the $163,000 unrealized loss (see Question 7.2.110).

See Example 7.5.80 for subsequent measurement.

7.3 Initial measurement: Common control transactions and asset acquisitions

Excerpt from ASC 805-50

Acquisition of Assets Rather than a Business

> Entities

15-2 The guidance in the Acquisition of Assets Rather than a Business Subsections applies to all entities.

> Transactions

15-3 The guidance in the Acquisition of Assets Rather than a Business Subsections applies to a transaction or event in which assets acquired and liabilities assumed do not constitute a **business**.

15-4 The guidance in the Acquisition of Assets Rather than a Business Subsections does not apply to the initial measurement and recognition by a primary beneficiary of the assets and liabilities of a variable interest entity (VIE) when the VIE does not constitute a business. Guidance for such a VIE is provided in Section 810-10-30.

> Acquisition Date Recognition of Consideration Exchanged

25-1 Assets commonly are acquired in exchange transactions that trigger the initial recognition of the assets acquired and any liabilities assumed. If the consideration given in exchange for the assets (or net assets) acquired is in the form of assets surrendered (such as cash), the assets surrendered shall be derecognized at the date of acquisition. If the consideration given is in the form of liabilities incurred or equity interests issued, the liabilities incurred and **equity interests** issued shall be initially recognized at the date of acquisition. However, if the assets surrendered are nonfinancial assets or **in substance nonfinancial assets** within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets surrendered shall be derecognized in accordance with the guidance in Subtopic 610-20 and the assets acquired shall be treated as noncash consideration in accordance with Subtopic 610-20.

> Determining Cost

30-1 Paragraph 805-50-25-1 discusses exchange transactions that trigger the initial recognition of assets acquired and liabilities assumed. Assets are recognized based on their cost to the acquiring entity, which generally includes the transaction costs of the asset acquisition, and no gain or loss is recognized unless the **fair value** of noncash assets given as consideration differs from the assets' carrying amounts on the acquiring entity's books. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in **substance nonfinancial assets** within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

30-2 Asset acquisitions in which the consideration given is cash are measured by the amount of cash paid, which generally includes the transaction costs of the asset acquisition. However, if the consideration given is not in the form of cash (that is, in the form of noncash assets, liabilities incurred, or **equity interests** issued), and no other generally accepted accounting principles (GAAP) apply (for example, Topic 845 on nonmonetary transactions or Subtopic 610-20), measurement is based on either the cost which shall be measured based on the fair value of the consideration given or the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

> Allocating Cost

30-3 Acquiring assets in groups requires not only ascertaining the cost of the asset (or net asset) group but also allocating that cost to the individual assets (or individual assets and liabilities) that make up the group. The cost of such a group is determined using the concepts described in the preceding two paragraphs. The cost of a group of assets acquired in an asset acquisition shall be allocated to the individual assets acquired or liabilities assumed based on their relative fair values and shall not give rise to **goodwill**. The allocated cost of an asset that the entity does not intend to use or intends to use in a way that is not its highest and best use, such as a brand name, shall be determined based on its relative fair value. See paragraph 805-50-55-1 for an illustration of the relative fair value method to assets acquired outside a business combination.

Excerpt from ASC 805-50

Transactions Between Entities Under Common Control

> Transfer Date Recognition

25-2 When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the **equity interests** shall initially recognize the assets and liabilities transferred at the date of transfer. See the Transactions Between Entities Under Common Control Subsection of Section 805-50-45 for guidance on the presentation of financial statements for the period of transfer and comparative financial statements for prior years.

> Transfer Date Measurement

30-5 When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the

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

30-6 In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method shall be applied retrospectively, and financial statements presented for prior periods shall be adjusted unless it is impracticable to do so. Section 250-10-45 provides guidance if retrospective application is impracticable.

Excerpt from ASC 810-10

Variable Interest Entities

> Valuation of Assets, Liabilities, and Noncontrolling Interests in a Newly Consolidated VIE

>> Entities under Common Control

30-1 If the **primary beneficiary** of a **variable interest entity** (VIE) and the VIE are under common control, the primary beneficiary shall initially measure the assets, liabilities, and **noncontrolling interests** of the VIE at amounts at which they are carried in the accounts of the reporting entity that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles [GAAP]).

>> All Primary Beneficiaries

30-3 When a reporting entity becomes the primary beneficiary of a VIE that is not a business, no goodwill shall be recognized. The primary beneficiary initially shall measure and recognize the assets (except for goodwill) and liabilities of the VIE in accordance with Sections 805-20-25 and 805-20-30. However, the primary beneficiary initially shall measure assets and liabilities that it has transferred to that VIE at, after, or shortly before the date that the reporting entity became the primary beneficiary at the same amounts at which the assets and liabilities would have been measured if they had not been transferred. No gain or loss shall be recognized because of such transfers.

30-4 The primary beneficiary of a VIE that is not a business shall recognize a gain or loss for the difference between (a) and (b):

a. The sum of:

   1. The fair value of any consideration paid
   2. The fair value of any noncontrolling interests
   3. The reported amount of any previously held interests

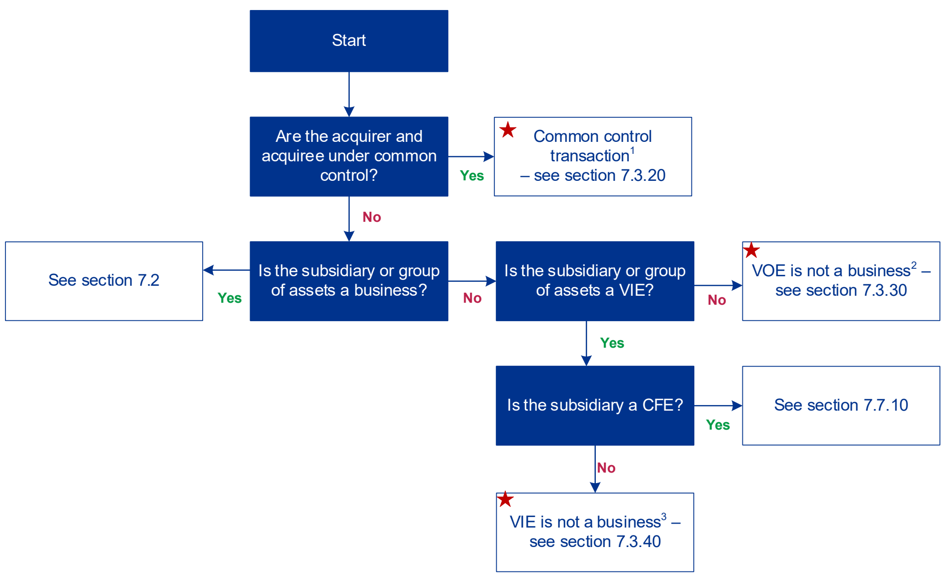
b. The net amount of the VIE's identifiable assets and liabilities recognized and measured in accordance with Topic 805.

7.3.10 Overview

Initial measurement on consolidation depends on whether the legal entity or group of assets being consolidated (the 'subsidiary') is under common control with the parent and if not, whether it meets the definition of a business as shown in the following diagram.

This section discusses initial measurement if the subsidiary is:

— under common control with the parent;
— a VOE that is not a business; or
— a VIE that is not a business and not a CFE to which the measurement alternative is applied.



Notes:
1. Apply Subtopic 805-50 (carryover basis). If the acquiree is a VIE, apply carryover basis under Subtopic 810-10
2. Apply Subtopic 805-50 (relative fair value)
3. Apply Subtopic 810-10 (fair value gain or loss)

When the subsidiary is not a business (i.e. the transaction is an asset acquisition), different initial measurement guidance applies depending on whether the subsidiary is a VIE.

The definition of a business was changed by ASU 2017-01, Clarifying the Definition of a Business. The amendments are fully effective for PBEs. For other entities, the amendments are effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019; early adoption is permitted. For in-depth guidance on whether a set of assets and activities is a business, see section 2 (from paragraph 2.026) of KPMG Handbook, Business combinations.

Common control transactions

When a subsidiary that is under common control (see Question 3.8.230) with the parent is initially consolidated, it is acquired in a common control transaction. Common control transactions are measured at the previous owner's carryover basis. If the previous owner's carryover basis differs from common control parent's historical cost, the acquired assets and liabilities are measured at the common control parent's historical cost. The accounting is discussed in section 7.3.20. [805-50-30-5]

If the net assets of a business are transferred in a common control transaction, the combination results in a change in reporting entity. As a result, comparative periods in which the entities were under common control are presented are retrospectively revised. The accounting is sometimes referred to as the 'as-if-pooling of interests' method. [805-50-45-4 – 45-5, 250-10 Glossary]

If the net assets of a legal entity that is not a business are transferred in a common control transaction, comparative periods are not retrospectively revised because there has been no change in the reporting entity under Topic 250 (see section 3.6 in KPMG Handbook, Accounting changes and error corrections). The transaction is recognized at the acquisition date and accounted for prospectively. [250-10 Glossary]

Acquiring a VOE that is not a business

When a VOE that is not a business is initially consolidated, it is acquired in an asset acquisition. [810-10-30-3]

Asset acquisitions are measured based on their cost to the acquirer. Cost is generally allocated to the assets acquired based on their relative fair values and goodwill is not recognized. The accounting is discussed in section 7.3.30.

Acquiring a VIE that is not a business

A primary beneficiary that initially consolidates a VIE that is not a business and is not under common control with the primary beneficiary applies the initial recognition guidance in Subtopic 810-10.

Similar to other asset acquisitions, a primary beneficiary of a newly consolidated VIE that is not a business does not recognize goodwill. The primary beneficiary initially measures the assets, liabilities and NCI of the newly consolidated VIE at fair value as of the date it meets the primary beneficiary criteria (unless the VIE is a CFE to which the measurement alternative has been applied). This can result in a gain or loss on consolidation. The accounting is discussed in section 7.3.40. [810-10-30-3 – 30-4]

If the VIE is a CFE, a primary beneficiary may elect to measure certain CFE's financial assets and financial liabilities using the measurement alternative. The measurement alternative allows the primary beneficiary to measure both the financial assets and the financial liabilities of the CFE based on the more observable of the fair value of the assets or the fair value of the liabilities. The accounting is discussed in section 7.7.10.

7.3.20 Common control transactions

Question 7.3.10

How does an entity initially measure the assets, liabilities and NCI of a VOE acquired in a common control transaction?

Background: Combinations between entities or businesses under common control result in a shift of ownership of the net assets or equity investments within the common control group and therefore do not meet the definition of a business combination. As a result, acquisitions of businesses and non-businesses from an entity under common control are out of the scope of the business combinations guidance.

Interpretive response: Combinations of entities under common control are recognized by the receiving entity (new parent) at the transfer date and are measured at the carrying amount of the transferring entity. [805-50-15-6, 25-2, 30-5]

However, the newly consolidated subsidiary's carrying amounts of the assets and liabilities transferred may differ from those of the ultimate parent of the entities under common control (e.g. because push-down accounting was not applied). In this case, the new parent measures the transferred assets and liabilities at the ultimate parent's carrying amounts. The new parent recognizes in equity any difference between the consideration paid and the net assets recognized. We believe costs associated with the common control transaction should be expensed in the period incurred unless the accounting for such costs is addressed by other guidance – e.g. debt or equity issuance costs. [805-50-30-5]

Question 7.3.20 addresses combinations of entities under common control when the subsidiary is a VIE. While the recognition and measurement principles are similar to those in Subtopic 805-50, the initial consolidation of a VIE under common control is addressed in Subtopic 810-10.

Example 28.2b in KPMG Handbook, Business combinations, illustrates the accounting.

Question 7.3.20

How does an entity initially measure the assets, liabilities and NCI of a VIE acquired in a common control transaction?

Interpretive response: If a VIE is under common control with its primary beneficiary, the receiving entity (primary beneficiary) initially measures the VIE's assets, liabilities and NCI at the previous parent's carrying amounts. If the previous parent's carrying amount differs from the common control parent's historical cost, the acquired assets and liabilities are generally measured at the common control parent's historical cost.

No gain or loss may be recognized on consolidation. [810-10-30-1]

Question 7.3.30

How does an investor transition from the equity method to consolidation when it obtains a controlling financial interest in a common control transaction?

Interpretive response: When an equity method investor increases its ownership (or its influence) to a level at which it obtains a controlling financial interest in an investee, it stops applying the equity method. The investor does not remeasure its previously held interest in the investee if the investor and seller are under common control. It measures the assets acquired, liabilities assumed and NCI at the ultimate parent's carrying amount (see Questions 7.3.10 and 7.3.20). [805-50-30-5]

7.3.30 Acquiring a VOE that is not a business

Question 7.3.40

How are assets acquired in an asset acquisition initially measured?

Interpretive response: Asset acquisitions are measured based on their cost to the acquirer. Cost includes the following. [805-50-30-1 – 30-2]

Cash consideration	Previously held interest	Direct acquisition-related costs
Noncash consideration	NCI	Contingent consideration

Cost excludes amounts attributable to other transactions that are not part of the asset acquisition – e.g. services provided by the seller.

An acquiring entity allocates the cost of an asset acquisition to the assets acquired generally based on their relative fair values. Fair value is determined under Topic 820. [805-50-30-3]

Goodwill is not recognized in an asset acquisition. Further, when the net fair value of the assets acquired and liabilities assumed is greater than the cost, a bargain purchase gain is not generally recognized in an asset acquisition. [805-50-30-3]

See KPMG Handbook, Asset acquisitions, for additional guidance on asset acquisitions.

Question 7.3.50

What are some of the key differences between accounting for asset acquisitions and business combinations?

Interpretive response: Some of the key differences between initially consolidating a business versus a group of assets are included in the following table. Subtopics 805-10 to 805-40 address business combinations. Subtopic 805-50 addresses asset acquisitions.

Asset acquisition	Business combination (section 7.2)
Initial measurement and allocation	
The acquirer measures the assets acquired based on their cost, which is generally allocated to the assets on a relative fair value basis.	The acquirer measures identifiable assets and liabilities generally at fair value.
Intangible assets	
Intangible assets are recognized if they meet the recognition criteria in FASB Concepts Statement No. 5, which is a lower recognition threshold than the criteria for intangible assets acquired in a business combination.	Intangible assets are recognized if they meet the contractual-legal criterion or the separability criterion. Private companies and NFPs may elect an accounting policy to subsume into goodwill noncompete agreements and customer-related intangible assets that cannot be sold or licensed separately from other assets of the business.
Goodwill	
Goodwill is not recognized. Generally, the acquirer allocates any excess cost over the fair value of the net assets acquired on a relative fair value basis to certain nonfinancial assets acquired.	Any excess consideration transferred over the fair value of the net assets acquired is goodwill and is recognized as a separate asset.
Bargain purchase amount	
Similar to goodwill, the acquirer should allocate a bargain purchase amount only to certain nonfinancial assets on a relative fair value basis.	The acquirer recognizes a bargain purchase gain immediately in net income.

See KPMG Handbook, Asset acquisitions, for additional guidance on asset acquisitions and the key differences from business combinations.

Question 7.3.60

How does a parent initially measure the assets acquired and liabilities assumed when it consolidates a VOE that is not a business?

Interpretive response: The acquirer in an asset acquisition generally measures the transaction at its cost and allocates the cost to the assets acquired, liabilities assumed, and NCI based on their relative fair values. [805-50-30-1 – 30-2]

The acquirer generally performs the cost allocation in two steps. First, it identifies the assets acquired and liabilities assumed and determines their fair values.

Second, it compares the cost to the total fair value from the first step. [805-5-30-1]

- When the cost is greater than the fair value of the assets acquired and the liabilities assumed (there is excess cost), Subtopic 805-50 precludes recognizing goodwill.
- When the cost is less than the fair value (bargain purchase amount), Subtopic 805-50 precludes recognizing gains (including a bargain purchase gain), unless the fair value of noncash consideration transferred exceeds its carrying amount.

Excess cost

When there is excess cost, the parent first confirms that all assets have been identified and allocated value. Then the excess cost is generally allocated to the nonfinancial assets acquired. We do not believe excess cost should be allocated to:

- financial assets (except equity method investments);
- assets held-for-sale;
- deferred tax assets;
- post-retirement benefit assets;
- other current assets (including inventory);
- indefinite-lived intangible assets;
- contract assets under Topic 606; or
- indemnification assets.

Bargain purchase amount

When there is a bargain purchase amount, we believe the acquirer generally should follow the same guidance used when there is excess cost, with one exception. We believe the acquirer should allocate a bargain purchase amount to indefinite-lived intangible assets; this is because it will not result in the immediate recognition of an impairment loss.

If a bargain purchase remains after allocating the bargain purchase amount to eligible assets (including indefinite-lived intangible assets), we believe an entity should allocate the bargain amounts to the remaining assets to avoid recognizing a bargain gain. If other relevant GAAP subsequently requires the asset(s) to be measured at fair value – in which case, there would be a gain recognized in that reporting period – the subsequent measurement and resulting gain should generally be recorded in accordance with that GAAP.

See section 3 of KPMG Handbook, Asset acquisitions, for additional discussion on determining the cost of an asset acquisition, and section 4 on allocating the cost.

Question 7.3.70

How does a parent measure NCI when it consolidates a VOE that is not a business?

Interpretive response: Subtopic 805-50 does not specifically address the measurement of NCI. When the parent obtains a controlling financial interest in a VOE that is not a business, we believe it has an accounting policy election to measure NCI at either a carryover basis or fair value. See Question 3.4.20 and Example 3.4.20 in KPMG Handbook, Asset acquisitions for additional discussion.

In addition, the entity should apply the accounting policy consistently, and any change to its policy would need to follow Topic 250. See section 3.3 in KPMG Handbook, Accounting changes and error corrections for additional discussion.

Question 7.3.80

If a parent's accounting policy is to initially measure NCI at fair value, is a noncontrolling discount applied?

Interpretive response: It depends. Quoted market prices, if available, generally provide the best evidence of fair value for NCI. Topic 820 prohibits adjustments, such as a noncontrolling discount, to quoted market prices when determining fair value. However, the price paid by the acquirer to obtain the controlling interest may include a control premium, in which case the per-share fair value of the NCI would be less than per-share fair value of the acquirer's interest. Therefore, in the absence of quoted market prices, a noncontrolling discount may be appropriate when estimating the fair value of NCI.

See Question 3.4.30 in KPMG Handbook, Asset acquisitions, for additional guidance.

Question 7.3.90

How does the acquirer measure the value of its interest in a previously held asset when it subsequently obtains control of that asset?

Background: An enterprise may acquire assets by obtaining a controlling financial interest in a legal entity that holds the assets. For example, an enterprise with a 20% interest in an entity that holds assets (e.g. real estate) that do not constitute a business may obtain an additional 50% interest in the entity so that it now holds a 70% controlling financial interest. In that case, the enterprise needs to determine how to account for its previously held interest.

Interpretive response: We believe a parent generally should value the previously held equity interest in an asset acquisition at carryover basis.

Subtopic 805-50 does not specifically address situations in which an entity obtains control of assets in which it previously held an interest. However, it indicates that assets are recognized based on their cost to the acquiring entity. We believe measuring the previously held equity interest at its carryover basis is the approach that is most consistent with this principle. [805-50-30-1]

However, we are aware of some diversity in practice in this area. We understand that in certain circumstances some entities remeasure a previously held equity interest to fair value at the acquisition date by analogy to the guidance on business combinations. [805-30-30-1]

See Question 3.4.10 in KPMG Handbook, Asset acquisitions, for additional guidance.

Question 7.3.100

How does a parent (acquirer) account for the contribution of previously controlled assets to an entity in exchange for a controlling financial interest?

Background: An acquirer contributes previously controlled noncash assets in exchange for a controlling financial interest in another entity in a transaction accounted for as an asset acquisition. No other consideration is transferred.

Interpretive response: This transaction raises questions about the accounting for the contributed assets, the measurement of NCI and the measurement of the net assets acquired.

Contributed assets	Absent specific guidance in Subtopic 805-50, we believe entities should continue to recognize the contributed noncash assets at carryover basis (see Question 7.3.90). This would be the case even when the acquirer obtains less than 100% of the equity interests in the acquired entity. If the acquirer contributes cash, we believe any cash immediately distributed to the seller is accounted for as consideration transferred. Cash that stays in the entity is accounted for similar to noncash contributed assets. [805-30-30-8]
Measurement of NCI	In the background transaction, we believe there are effectively two components that affect the measurement of NCI in the acquired entity: — the NCI's proportionate interest in the carrying amount of the contributed assets immediately preceding the transaction; and [805-30-30-8, 810-10-45-23] — the value of the acquired entity's NCI (excluding the contributed assets) measured based on the acquirer's

	accounting policy for measuring NCI in an asset acquisition, either at carryover basis or fair value (see Question 7.3.70).
Measurement of acquired assets	While the contributed assets are measured at carryover basis, we believe the total cost of the new assets acquired should include all of the following: — the fair value of the ownership interest in the contributed assets given up. [805-30-30-2] — the measurement of the NCI in the acquired entity (excluding the contributed assets), which is based on carryover basis or fair value (see above). — any other consideration transferred to the seller. Any difference between the carrying amount of the NCI related to the contributed assets and fair value of the interest given up should be recognized in APIC. [810-10-45-23]

See Question 3.4.25, Example 3.4.30 and Example 3.4.40 in KPMG Handbook, Asset acquisitions, for additional guidance.

Question 7.3.110

How does an investor transition from the equity method to consolidation when it obtains a controlling financial interest in a VOE that is not a business?

Interpretive response: When an equity method investor increases its ownership (or its influence) to a level at which it obtains a controlling financial interest in an investee, it stops applying the equity method.

As discussed in Question 7.3.90 in the context of single-asset investees, the investor does not remeasure its previously held interest in the investee if the investee is a VOE and not a business. In these situations, the investor measures the previously held equity interest at its carryover basis. [805-50-30-1]

However, we are aware of some diversity in practice in this area. We understand that, in certain circumstances, some entities remeasure a previously held equity interest to fair value at the acquisition date by analogy to the guidance on business combinations. [805-30-30-1]

When transitioning from equity method to consolidation, there may be implications for previously recognized deferred tax liabilities and deferred tax assets. This is because there are exceptions to recognizing deferred tax assets and liabilities related to outside basis differences in subsidiaries that do not apply to equity method investments.

See Question 6.2.60 in KPMG Handbook, Equity method of accounting, and section 6 of KPMG Handbook, Accounting for income taxes, for additional guidance.

7.3.40 Acquiring a VIE that is not a business

Question 7.3.120#

How does a parent initially measure the assets, liabilities and NCI when it consolidates a VIE that is not a business?

Interpretive response: The primary beneficiary of a VIE that is not a business generally measures the assets acquired, liabilities assumed and any NCI at their acquisition-date fair values under the acquisition method principles in Topic 805 (business combinations) (see Question 7.2.80). [810-10-30-3]

However, the primary beneficiary is precluded from recognizing goodwill. Further, it must measure the assets and liabilities that it recently transferred to the VIE at carryover basis (see Question 7.3.140). [810-10-30-3]

The primary beneficiary recognizes on consolidation a gain or loss for the difference between: [810-10-30-4]

- the aggregate of:
  - the fair value of the consideration paid;
  - the fair value of any NCI; and
  - the reported amount of any previously held interests; and
- the net amount of the VIE's identifiable assets and liabilities recognized and measured under Subtopic 805-20.

The guidance above refers to Subtopic 805-20 for initial recognition and measurement, but it does not provide specific guidance on the subsequent accounting for the assets and liabilities recognized. This has led to diversity in practice on certain topics such as contingent consideration and IPR&D. The FASB recognized this diversity and added the accounting for contingent consideration and IPR&D in a VIE that is not a business to its agenda as part of the Improving the Accounting for Asset Acquisitions and Business Combinations project. That project was subsequently removed from the FASB's agenda; therefore, we believe diversity in practice will continue and the following would be acceptable for contingent consideration and IPR&D.

Contingent consideration

We believe contingent consideration should be initially recognized at fair value consistent with the initial recognition and measurement requirements in the business combinations guidance. While Topic 810 does not provide specific guidance on the subsequent measurement of contingent consideration, we believe the contingent consideration should be remeasured to fair value each reporting period with changes in fair value reported in earnings consistent with the business combinations guidance used for initial recognition and measurement. See section 12 of KPMG Handbook, Business Combinations, for initial and subsequent accounting for contingent consideration. [810-10-30-3]

However, as a result of the diversity in practice, we believe other approaches may also be acceptable for the subsequent accounting for contingent consideration depending on the facts and circumstances.

IPR&D

IPR&D is initially recognized and measured at fair value consistent with the business combinations guidance in Subtopic 805-20. However, there is diversity in the subsequent accounting and we believe either of the following approaches are acceptable.

- The amount initially allocated and recognized for IPR&D is expensed immediately in accordance with Subtopic 730-10 (research and development) unless it has an alternative future use, in which case it is accounted for as an intangible asset (see Question 4.2.20). Under this approach, the entity follows the asset acquisition approach because of the specific guidance in Subtopic 730-10.
- The IPR&D continues to be accounted for as an indefinite-lived intangible asset consistent with IPR&D acquired in a business combination. Under this approach, the entity continues to follow the business combinations guidance consistent with the initial recognition and measurement of the IPR&D as required under Subtopic 810-10. See section 17 of KPMG Handbook, Business Combinations, for additional guidance on the accounting for IPR&D.

See KPMG Handbook, Asset Acquisitions, for additional guidance.

Question 7.3.130

How does an investor transition from the equity method to consolidation when it obtains a controlling financial interest in a VIE that is not a business?

Interpretive response: When an equity method investor increases its ownership (or its influence) to a level at which it obtains a controlling financial interest in an investee, it stops applying the equity method.

If the investee is a VIE but not a business, the investor does not remeasure its previously held interest in the investee. The reported amount of the previously held interest factors into the gain or loss recognized on consolidation (see Question 7.3.120).

When transitioning from equity method to consolidation, there may be implications for previously recognized deferred tax liabilities and deferred tax assets. This is because there are exceptions to recognizing deferred tax assets and liabilities related to outside basis differences in subsidiaries that do not apply to equity method investments.

See Question 6.2.60 in KPMG Handbook, Equity method of accounting, and section 6 of KPMG Handbook, Accounting for income taxes, for additional guidance.

Question 7.3.140

How does a primary beneficiary measure assets that it recently transferred to a VIE?

Interpretive response: If a primary beneficiary transfers assets and/or liabilities to a VIE upon, after or shortly before becoming the primary beneficiary, it initially measures them at the primary beneficiary's carryover basis. As a result, no gain or loss is recognized from such transfers. [810-10-30-3]

The FASB included this provision to prevent a primary beneficiary from recognizing gains or losses selectively (and thereby affecting profits or losses) by transferring assets and/or liabilities to a VIE.

Example 7.3.10

Initial consolidation of a nonbusiness VIE lessor

Background

Enterprise Lessee enters into a lease with VIE Lessor. The lease is structured so that Enterprise Lessee classifies it as an operating lease and VIE Lessor classifies it as a direct financing lease. In its separate financial statements, VIE Lessor reports a direct financing lease receivable and unearned income. The net investment in the lease is VIE Lessor's only asset.

Enterprise Lessee is required to consolidate VIE Lessor because it is the primary beneficiary. Enterprise Lessee must determine what kind of asset to recognize in its consolidated financial statements.

Evaluation

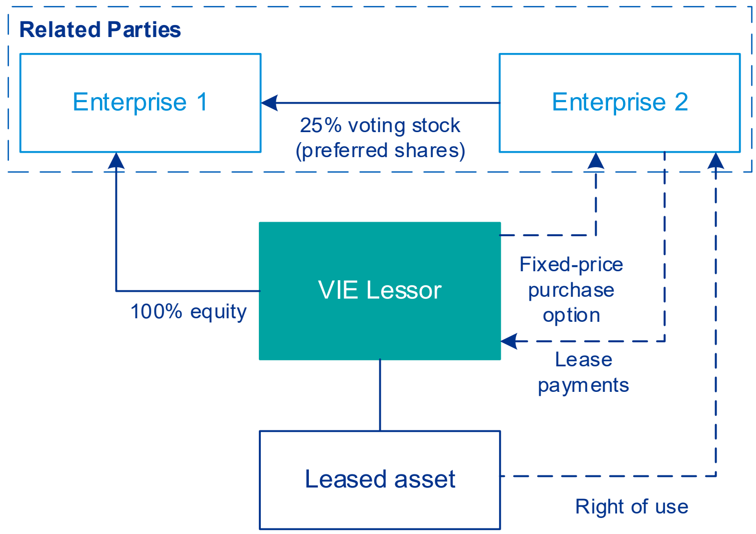
No lease exists in Enterprise Lessee's consolidated financial statements because the intercompany lease is eliminated in consolidation. Therefore, Enterprise Lessee should record on its balance sheet the physical asset that was on the VIE Lessor's balance sheet immediately before entering into the lease arrangement.

Example 7.3.20

Initial consolidation of a nonbusiness VIE – fair value of liabilities exceeds fair value of assets

Background

VIE Lessor is the lessor in a single-asset leasing arrangement with Enterprise2 (the lessee) and has no other assets or operations other than those related to this leasing arrangement. Due to the existence of a fixed-price purchase option in the lease between VIE Lessor and Enterprise2, Enterprise2 is considered to have a variable interest in VIE Lessor. Enterprise2 has no voting interest or other variable interest in VIE Lessor.



The related party group (Enterprise1 and Enterprise2) collectively meets the primary beneficiary criteria (see section 6.5.30). After applying the related party tiebreaker test (see Question 6.5.240), it is determined that, due to its use of the leased asset, Enterprise2 is most closely associated with VIE Lessor. Enterprise2 is therefore required to consolidate VIE Lessor.

VIE Lessor's asset and liability are as follows. The difference is the fair value of Enterprise1's equity interest in VIE Lessor.

	Book value	Fair value
Asset	$ 200	$ 100
Liability	(150)	(200)
Difference	$ 50	$ (100)

Evaluation

The difference between the fair value of the asset and liability (negative $100) represents the fair value of VIE Lessor's equity (deficit) at the date of consolidation. Because VIE Lessor's equity is owned 100% by Enterprise1, Enterprise2 records the following journal entry when consolidating VIE Lessor.

	Debit	*Credit*
Leased asset	100	
NCI	100	
Liability		200
To consolidate VIE Lessor with 100% NCI.		

Question 7.3.150

How does a primary beneficiary present beneficial interests held by unrelated third parties in a securitization entity?

Interpretive response: In our experience, primary beneficiaries (sponsors) generally account for all beneficial interests held by third parties in a consolidated securitization entity, including legal-form equity interests, as nonrecourse borrowings in their consolidated financial statements. That is, sales of beneficial interests in an asset-backed structure are not accounted for as NCI, but instead as obligations to remit cash flows from the assets in the trust pursuant to the specified distribution waterfall.

Sales of interests in a VIE with the following characteristics represent in-substance financing transactions:

— holds only financial assets; and
— is not a business.

Regardless of whether the beneficial interests are senior or junior, or in-form equity or in-form debt, we believe they represent sales of a portion of the cash flows of the assets in the securitization trust. Sales of interests in financial assets' cash flows are required to be accounted for as secured borrowings under Topic 860 (transfers and servicing) if the criteria for derecognizing the asset itself are not met.

Because all beneficial interests in securitization structures are liability-classified upon consolidation by the primary beneficiary, we believe any differences that arise between accounting for the assets and liabilities should generally be attributed to the primary beneficiary (controlling interest) even if it is not economically absorbing that difference.

7.4 Subsequent measurement

7.4.10 General consolidation procedure

Excerpt from ASC 810-10

General

> Entities

15-11 A difference in fiscal periods of a parent and a subsidiary does not justify the exclusion of the subsidiary from consolidation.

> Retention of Specialized Accounting for Investments in Consolidation

25-15 For the purposes of consolidating a subsidiary subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that subsidiary.

Variable Interest Entities

35-3 The principles of **consolidated financial statements** in this Topic apply to primary beneficiaries' accounting for consolidated **variable interest entities** (VIEs). After the initial measurement, the assets, liabilities, and **noncontrolling interests** of a consolidated VIE shall be accounted for in consolidated financial statements as if the VIE were consolidated based on voting interests. Any specialized accounting requirements applicable to the type of business in which the VIE operates shall be applied as they would be applied to a consolidated **subsidiary**. The consolidated entity shall follow the requirements for elimination of intra-entity balances and transactions and other matters described in Section 810-10-45 and paragraphs 810-10-50-1 through 50-1B and existing practices for consolidated subsidiaries. Fees or other sources of income or expense between a **primary beneficiary** and a consolidated VIE shall be eliminated against the related expense or income of the VIE. The resulting effect of that elimination on the net income or expense of the VIE shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.

General

> Procedures

45-1 In the preparation of **consolidated financial statements**, intra-entity balances and transactions shall be eliminated. This includes intra-entity open account balances, security holdings, sales and purchases, interest, dividends, and so forth. As consolidated financial statements are based on the assumption that they represent the financial position and operating results of a single economic entity, such statements shall not include gain or loss on transactions among the entities in the consolidated group. Accordingly, any intra-entity profit or loss on assets remaining within the **consolidated group** shall be eliminated; the concept usually applied for this purpose is gross profit or loss (see also paragraph 810-10-45-8).

45-2 The retained earnings or deficit of a **subsidiary** at the date of acquisition by the **parent** shall not be included in consolidated retained earnings.

45-4 When a subsidiary is initially consolidated during the year, the consolidated financial statements shall include the subsidiary's revenues, expenses, gains, and losses only from the date the subsidiary is initially consolidated.

45-5 Shares of the parent held by a subsidiary shall not be treated as outstanding shares in the consolidated statement of financial position and, therefore, shall be eliminated in the consolidated financial statements and reflected as treasury shares.

45-8 If income taxes have been paid on intra-entity profits on **inventory** remaining within the consolidated group, those taxes shall be deferred or the intra-entity profits to be eliminated in consolidation shall be appropriately reduced.

45-9 Occasionally, subsidiaries capitalize retained earnings arising since acquisition, by means of a stock dividend or otherwise. This does not require a transfer to retained earnings on consolidation because the retained earnings in the consolidated financial statements shall reflect the accumulated earnings of the consolidated group not distributed to the **owners** of, or capitalized by, the parent.

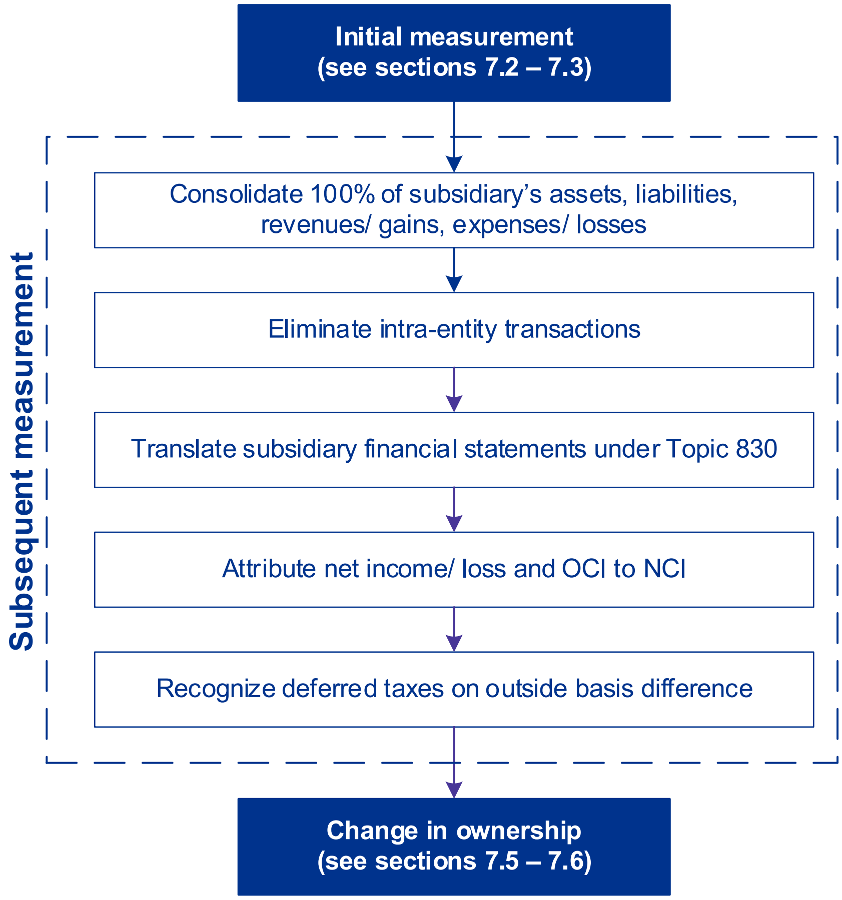
> Differing Fiscal Year-Ends Between Parent and Subsidiary

45-12 It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, financial statements for a period that corresponds with or closely approaches the fiscal period of the parent. However, if the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's financial statements for its fiscal period; if this is done, recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations.

> A Change in the Fiscal Year-End Lag Between Subsidiary and Parent

45-13 A parent or an investor should report a change to (or the elimination of) a previously existing difference between the parent's reporting period and the reporting period of a consolidated entity or between the reporting period of an investor and the reporting period of an equity method investee in the parent's or investor's consolidated financial statements as a change in accounting principle in accordance with the provisions of Topic 250. While that Topic generally requires voluntary changes in accounting principles to be reported retrospectively, retrospective application is not required if it is impracticable to apply the effects of the change pursuant to paragraphs 250-10-45-9 through 45-10. The change or elimination of a lag period represents a change in accounting principle as defined in Topic 250. The scope of this paragraph applies to all entities that change (or eliminate) a previously existing difference between the reporting periods of a parent and a consolidated entity or an investor and an equity method investee. That change may include a change in or the elimination of the previously existing difference (lag period) due to the parent's or investor's ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the parent or investor. This paragraph does not apply in situations in which a parent entity or an investor changes its fiscal year-end.

The premise of consolidation is that consolidated financial statements represent the financial position and operating results of a single economic entity. They include the total of the parent and subsidiary accounts, reduced for any intra-entity transactions and activities. The following diagram summarizes consolidation procedure. [810-10-45-1]



Question 7.4.10

What are some key considerations when preparing consolidated financial statements?

Interpretive response: Some key considerations when preparing consolidated financial statements include:

Fiscal year-ends may be different	A parent and a subsidiary may have different fiscal year-ends, but this does not preclude consolidation. Although a parent will generally be able to obtain financial statements from a subsidiary as of its reporting date, it may use the subsidiary's financial statements as of its fiscal year-end if the timing difference is approximately three months or less. The parent recognizes or discloses the effect of material events that occurred in the intervening period (see section 8.3). [810-10-15-11, 45-12]
Financial information may not be timely	In some cases, there may be a lag in the availability of financial information from the subsidiary. A parent can use the most recently available financial statements from the subsidiary. Like differing fiscal years, the lag period should

	be approximately three months or less and disclosure should be provided (see section 8.3). [810-10-45-13] Any change to the lag period (resulting from a change in the availability of information) is considered a change in accounting principle under Topic 250 (accounting changes) and should be accounted for retrospectively unless it is impracticable to do so (see section 3.3 in KPMG Handbook, Accounting changes and error corrections). [810-10-45-13]
VIEs aren't treated (much) differently	After initial measurement, the primary beneficiary is required to account for the assets, liabilities and NCI of a consolidated VIE as though they were consolidated based on voting interests. This includes eliminating intra-entity balances and transactions. However, as an exception, a VIE's primary beneficiary does not attribute the effect of intra-entity eliminations to the NCI holder. [810-10-35-3]
Tax implications aren't eliminated	The difference between the financial statement carrying amount and the tax basis of a parent's investment in the stock of a subsidiary is known as an outside basis difference. This may result in a temporary difference even though the investment account is eliminated in the consolidated financial statements. Further, the individual tax effects of intra-entity transactions are not eliminated except for intra-entity sales of inventory.
Translation isn't only for language barriers	Individual subsidiaries within the consolidated financial statements may operate in different economic and currency environments and may prepare financial statements in their respective functional currencies, which is often the local currency. The functional currency financial statements of all subsidiaries (and investees accounted for under the equity method) must be translated into the parent's reporting currency. See KPMG Handbook, Foreign currency, for additional guidance on foreign currency matters.

Question 7.4.20

Must a parent and its consolidated subsidiary apply uniform accounting policies?

Interpretive response: Generally, yes. Although US GAAP does not specifically address this issue, we believe accounting policies should be conformed unless:

— dissimilar operations provide a basis for different accounting policies; or
— the subsidiary is applying industry-specific guidance (see Question 7.4.30).

This view is consistent with the guidance applicable to the assets acquired and liabilities assumed in a business combination – i.e. the acquirer and acquiree accounting policies are generally conformed.

Dissimilar operations

We believe accounting policies need not be conformed if dissimilar operations, assets or transactions provide a basis for different accounting policies and each entity in the consolidated financial statements follows an acceptable alternative under US GAAP.

For example, a subsidiary applies the first-in, first-out (FIFO) method for its inventory accounting, while the parent applies the last-in, last-out (LIFO) method for its inventory. Both methods may be applied concurrently in the consolidated financial statements because:

— both methods are acceptable under US GAAP; and
— using multiple methods of inventory costing is acceptable under US GAAP, even if applied by a single legal entity.

Accounting methods should be disclosed in the consolidated financial statements. [TQA 2140.11]

Change in accounting policy

The acquirer may change its accounting policies to conform to those of the acquiree. Such a change is a change in accounting principle. This is permitted only if the acquirer can justify use of an allowable alternative accounting principle that is preferable. See chapter 3 of KPMG Handbook, Accounting changes and error corrections, for further discussion. [250-10-45-12]

Newly established accounting policy

If the accounting acquirer does not have an established policy in relation to the asset acquired or liability assumed, the acquirer and acquiree can apply any accounting policy that is acceptable under US GAAP, including one that is different from what the acquiree had been applying before being consolidated by the parent. In this situation, the acquirer does not need to consider whether the accounting policy is preferable to the accounting policy previously applied by the acquiree.

Question 7.4.30

Does a parent retain the specialized accounting principles applied by a consolidated subsidiary?

Interpretive response: Yes. In some situations, the subsidiary applies industry-specific accounting principles provided for in the industry-specific Topics of US GAAP. Topic 810 requires an investor to retain those principles. [810-10-25-15]

The following are examples.

— A non-investment company parent that consolidates an investment company recognizes the investment company's net income based on its reported net income, which is measured under Topic 946.

— A broker-dealer in securities that consolidates a VIE recognizes the VIE's net income as reported by the VIE – i.e. it may not measure the VIE's assets and liabilities at fair value unless the VIE is required to do so under existing US GAAP (e.g. if the VIE is an investment company).

— An NFP parent that consolidates a for-profit entity recognizes the for-profit entity's net income as reported by the for-profit entity, even if the subsidiary applies principles that do not directly apply to the NFP (see Question 7.4.40).

Question 7.4.40

Does an NFP retain in the consolidated financial statements its for-profit subsidiary's VIE accounting?

Interpretive response: Yes. Although an NFP generally does not apply the VIE consolidation model to its direct investments/interests, an NFP parent should retain the VIE accounting applied by its for-profit subsidiary when it prepares its consolidated financial statements (see Question 7.4.30). [810-10-25-15, 15-19]

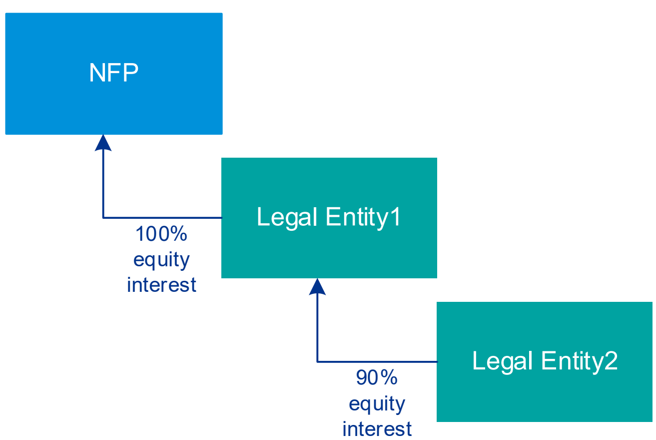
Example 7.4.10

Retention of a for-profit subsidiary's VIE accounting in the consolidated financial statements of an NFP

Background

NFP applies the guidance in Topic 958 and consolidates its wholly owned, for-profit subsidiary, Legal Entity1. Legal Entity1, which does not prepare separate financial statements, holds a 90% equity interest in Legal Entity2. Legal Entity1 has determined that:

— Legal Entity2 is a VIE; and
— Legal Entity1 is its primary beneficiary.



Evaluation

Although paragraph 810-10-15-17(a) indicates that NFPs are not generally subject to the VIE guidance, we believe NFP should retain the consolidation conclusion of Legal Entity1 and report Legal Entity2 in its consolidated financial statements under the VIE consolidation model.

NFP will report the 10% NCI in Legal Entity2 as a separate component of the appropriate class of NFP's net assets. See section 9.4 for guidance on NFPs.

Question 7.4.50

How does a parent consolidate a subsidiary that does not provide financial statements on a timely basis?

Background: Usually it is feasible for a subsidiary to prepare financial statements for a period corresponding with the fiscal period of the parent. However, in some cases, a subsidiary does not prepare its US GAAP financial statements timely enough for the parent to include them in the consolidated financial statements as of the same date as the parent's financial statements. [810-10-45-12]

Interpretive response: The parent may use the subsidiary's most recent financial statements, even when a lag exists, if: [810-10-45-12]

— the lag does not exceed 93 days;
— the lag is consistent from period to period for quarterly and annual reporting periods; and
— the subsidiary's most recent financial statements have been prepared for a reporting period of equal length to the parent's reporting period.

Any changes in the lag period should be treated as a change in accounting principle under Topic 250 (see Question 7.4.70). [810-10-45-13]

Question 7.4.60

How does a parent that applies lag reporting prepare consolidated financial statements in the first and last period of consolidation?

Interpretive response: We believe the parent should not recognize subsidiary net income in the consolidated financial statements that: [810-10-45-4]

— arose before it acquired the controlling interest; or
— are reported to the parent after it disposed of the controlling interest.

This convention will result in the parent recognizing subsidiary net income for a period shorter than the ownership period.

See Question 4.7.10 and Example 4.7.10. in KPMG Handbook, Equity method of accounting, for additional guidance.

Question 7.4.70

How does a parent account for changes in the lag period?

Interpretive response: A parent reports a change to (or elimination of) a lag period as a change in accounting principle under Topic 250. Topic 250 requires a reporting enterprise to retrospectively apply a voluntary change in accounting principle unless it is impracticable to do so. Further, the parent needs to demonstrate that the change is preferable and provide the required Topic 250 disclosures. [810-10-45-13, 250-10-45-9 – 45-40, 50-1 – 50-3]

See section 3.3 in KPMG Handbook, Accounting changes and error corrections for additional discussion.

Question 7.4.80

How does a parent prepare consolidated financial statements if the subsidiary has a different fiscal year-end?

Interpretive response: When a parent and subsidiary have different fiscal year-ends, we believe the parent should use the most recent subsidiary financial information available when preparing consolidated financial statements. This is similar to how a parent reports subsidiary activity on a lag because more recent information is not available (Question 7.4.50).

If the most recent subsidiary financial information available to the parent is the information that the subsidiary prepared at its fiscal period-end, we believe the parent may use that information if the subsidiary's fiscal period-end does not differ by more than three months from the parent's. The parent recognizes or discloses the existence of different year-ends and intervening events that may materially affect its financial position or results of operations. If the difference is more than three months, the parent should obtain from the subsidiary more recent financial information to prepare consolidated financial statements. [810-10-45-12]

The following table describes how to apply this guidance in different scenarios.

Subsidiary fiscal year-end	Parent fiscal year-end	Subsidiary provides to parent…	For consolidation, parent uses…
March 31	December 31	Monthly and quarterly financial statements; one-month lag	Subsidiary's November 30 financial information (Dec 1 – Nov 30)
January 31	December 31	Monthly and quarterly financial statements; in time for consolidation	Subsidiary's December 31 financial information (no lag necessary)

Subsidiary fiscal year-end	Parent fiscal year-end	Subsidiary provides to parent…	For consolidation, parent uses…
September 30	December 31	Quarterly and annual financial statements; one quarter lag	Subsidiary's September 30 financial information (Oct 1 – Sep 30)

See Question 4.7.80, and Examples 4.7.40 to 4.7.60, in KPMG Handbook, Equity method of accounting.

Question 7.4.90

Must all intra-entity transactions be eliminated in consolidation?

Interpretive response: Generally, yes. Topic 810 requires elimination of the following intra-entity items (not exhaustive): [810-10-45-1]

— open account balances;
— security holdings;
— sales and purchases;
— interest; and
— dividends.

The premise of intra-entity eliminations is that consolidated financial statements represent the financial position and operating results of a single economic entity and therefore should not include gains and losses on transactions between entities within that group.

However, certain effects of intra-entity transactions are recognized in the consolidated financial statements, including:

— the tax effects of intra-entity sales or services – except for sales of inventory (see Question 7.4.190);
— the tax effects of the outside basis differences in investments in subsidiaries (see Question 7.4.180);
— the effects of exchange rate changes on foreign currency transactions (see Question 7.4.160);
— the effects of hedging intra-entity foreign currency transactions (see Question 7.4.170); and
— the effects of hedging the net investment in a foreign operation (see Question 7.4.150).

Example 7.4.20
Intra-entity eliminations – downstream transaction

Background

Parent sells inventory with a cost of $105,000 to wholly owned Subsidiary for $150,000, resulting in intra-entity profit of $45,000.

At the end of the Year 1, Subsidiary has $30,000 (20%) of the acquired inventory on hand. Parent's intra-entity profit related to Subsidiary's remaining inventory is $9,000 ($45,000 × 20%).

During Year 2, Subsidiary sells the remaining $30,000 of inventory.

There were no other intra-entity transactions in Year 1 or Year 2.

This example ignores income tax effects.

Evaluation

Year 1 consolidating entries

The following table shows how Parent prepares its consolidation of Subsidiary at the end of Year 1.

			Consolidating entries		
	Parent	Subsidiary	Debit	Credit	Consolidated
Accounts receivable	$110,000	$ 37,000			$147,000
Inventory:					
From vendors	155,000	40,000			195,000
From Parent[2]		30,000		$ 9,000	21,000
Investment in Subsidiary[1]	100,000			100,000	----
PP&E (net)	350,000	125,000			475,000
Total assets	$715,000	$232,000		$109,000	$838,000
Liabilities	$355,000	$123,000			$478,000
Common stock[1]	250,000	100,000	$100,000		250,000
Retained earnings[2]	110,000	9,000	9,000		110,000
Total liabilities and equity	$715,000	$232,000	$ 109,000		$838,000

Notes:
1. Elimination of Parent's investment in Subsidiary and Subsidiary's common stock.
2. Elimination of intra-entity profit on inventory remaining on hand at the end of Year 1.

Year 2 consolidating entries

The following table shows how Parent prepares its consolidation of Subsidiary at the end of Year 2. This table assumes Parent reversed its Year 1 consolidating entries at the beginning of Year 2.

	Parent	Subsidiary	Consolidating entries		Consolidated
			Debit	Credit	
Cash	$68,000	$ 10,000			$78,000
Accounts receivable:	132,000	40,000			172,000
Inventory:					
From vendors	145,000	50,000			195,000
From Parent					----
Investment in Subsidiary[1]	100,000			100,000	----
PP&E (net)	305,000	120,000			425,000
Total assets	$750,000	$220,000		$100,000	$870,000
Liabilities	$285,000	$ 80,000			$365,000
Common stock[1]	250,000	100,000	$100,000		250,000
Retained earnings	215,000	40,000			255,000
Total liabilities and equity	$750,000	$220,000	$ 100,000		$870,000

Note:

1. Elimination of Parent's investment in Subsidiary and Subsidiary's common stock.

The following table shows a rollforward of consolidated retained earnings from the beginning of Year 1 to the end of Year 2.

Rollforward of consolidated retained earnings	
Beginning balance – beginning of Year 1	$119,000
Parent net income	105,000
Subsidiary net income	31,000
Elimination of intra-entity profit – Year 1	(9,000)
Year 2 recognition of profit eliminated from Year 1	9,000
Retained earnings – end of Year 2	$255,000

Question 7.4.100

Is the intra-entity elimination guidance the same for VIEs and VOEs?

Interpretive response: For the most part, yes. However, one significant difference that exists between the subsequent measurement requirements for VIEs and VOEs is the elimination of intra-entity profits and losses. [810-10-35-3]

Type of entity	Treatment
VIE	The effect of intra-entity eliminations must be attributed solely to the primary beneficiary. The VIE Subsections of Subtopic

Type of entity	Treatment
	810-10 do not permit the elimination of intra-entity profits or losses (including intra-entity fees) to be attributed to NCI.
VOE	The elimination of intra-entity profit or loss may be allocated between the parent and NCI. [810-10-45-18]

See section 7.5 for additional guidance on accounting for NCI.

Question 7.4.110

Is a subsidiary's position in its parent's debt securities eliminated in the consolidated financial statements?

Background: This situation arises most often when the consolidated financial statements include a broker-dealer subsidiary.

For example, Parent has a consolidated broker-dealer subsidiary (Broker-Dealer) that frequently acts as a participating underwriter in debt securities issuances of Parent and/or other affiliates (collectively referred to as Parent). As a result, Broker-Dealer will at times take positions in the debt securities of Parent when it is unable to distribute its entire underwriting inventory. These positions are typically placed in the Broker-Dealer's trading inventory and marked-to-market like other trading inventory items in third parties. The intent of Broker-Dealer is to sell such positions resulting from the undersubscribed underwriting within a short period.

Interpretive response: Yes. The purpose of consolidated statements is to present the results of operations and the financial position of a parent company and its subsidiaries as if the group were a single enterprise with one or more branches or divisions. As a result, we believe a subsidiary's position in its parent's debt securities should be eliminated in consolidation.

In the background example, we believe Broker-Dealer's position and Parent's debt should be eliminated in consolidation until a third-party owner holds the securities.

Question 7.4.120

Is a subsidiary's purchase of its parent's debt securities accounted for as debt extinguishment in the consolidated financial statements?

Background: This situation arises most often when the consolidated financial statements include a broker-dealer subsidiary.

For example, Parent has a consolidated broker-dealer subsidiary (Broker-Dealer) that participates in various trading activities, making a market in financial instruments, including debt securities.

Broker-Dealer will at times take positions in the debt securities of Parent and/or other affiliates (collectively referred to as Parent) by buying a position from a customer who wants to sell the securities, or by taking a temporary trading position from a noncustomer in the secondary market. The intent of Broker-Dealer in either situation is to sell such securities held in its trading portfolio within a short period.

When Broker-Dealer purchases Parent debt securities, it recognizes the position as a trading asset – i.e. like it does for any other trading position it holds in unrelated companies.

Interpretive response: Yes. If a debtor pays the creditor and is relieved of its obligation for the liability, a liability has been extinguished. Paying the creditor includes reacquisition by the debtor of its outstanding debt securities, whether the securities are canceled or held as treasury bonds. [405-20-40-1]

In the background example, we believe Broker-Dealer's purchase of Parent's debt securities should be accounted for in the consolidated financial statements as an extinguishment of Parent's debt. Further, any extinguishment gain or loss should be recognized, including the writeoff of any related unamortized debt issuance costs. A resale of the debt securities by Broker-Dealer should be accounted for as a new issuance of debt securities in the consolidated financial statements.

Question 7.4.130

How are the consolidated financial statements prepared when the parent and subsidiary have different functional currencies?

Interpretive response: Individual subsidiaries within the consolidated financial statements may operate in different economic and currency environments and may prepare financial statements in their respective functional currencies, which is often the local currency.

Under Topic 830, the functional currency financial statements of all subsidiaries (and investees accounted for under the equity method) must be translated into the parent's reporting currency. [830-10-10-1, 15-3 – 15-4, 830-30-45-3]

The subsidiary's financial statements are translated from its functional currency to the parent's reporting currency using a current exchange rate. [830-30-45-3]

Current exchange rate	The rate at which one unit of a currency can be exchanged for another currency

This rate differs depending on the nature of the financial statement account. The following summarizes which rate to use depending on type of account. [830-30-45-3, 830-10-55-10 – 55-11]

Assets and liabilities	Reporting date
Revenues, expenses, gains and losses	Dates when each element was recognized or the weighted-average exchange rate for the period
Equity accounts	Historical exchange rate

The process of translating a subsidiary's foreign currency financial statements results in translation adjustments, which are recognized as a component of OCI. Translation adjustments arise from the differences between the:

- prior period-end exchange rate and the current period-end exchange rate on the translation of opening net assets;
- transaction date (or appropriately weighted average) rates and current period-end rate on translation of income statement items; and
- transaction date rates and current period-end rate on translation of contributions and distributions from equity.

See section 4 of KPMG Handbook, Foreign currency, for a discussion of foreign currency translation.

Question 7.4.140

Which current exchange rate is used to translate a foreign subsidiary's financial statements if its fiscal year-end differs from the parent?

Interpretive response: If a foreign subsidiary's reporting date differs from that of the parent, the following rates should be used for translation: [830-30-45-8]

- the exchange rate in effect at the foreign subsidiary's reporting date; and
- an appropriately weighted-average exchange rate for the foreign subsidiary's fiscal period.

The parent does not adjust for rate changes after the foreign subsidiary's reporting date. However, it should disclose significant effects of rate changes after the reporting date on unsettled balances of foreign currency transactions. [830-30-45-16]

See section 4 of KPMG Handbook, Foreign currency, for additional discussion.

Question 7.4.150

Can a parent hedge its investment in a foreign subsidiary?

Interpretive response: Yes, if certain criteria are met. A hedge of the exposure to foreign currency risk of a net investment in a foreign operation is a referred to as a net investment hedge.

- Net investment hedges are subject to the following hedging criteria.
- The operating unit with the foreign currency exposure needs to be a party to the hedging instrument. [815-20-25-30(a)]
- The hedged net investment needs to be denominated in a currency other than the entity's functional currency. [815-20-25-30(b)]
- The entity needs to formally document the hedging relationship. The documentation requirements for net investment hedges are the same as those for other hedging relationships. [815-20-25-3(b)]
- The entity needs to assess effectiveness at least quarterly and whenever financial statements or net income are reported. [815-35-35-27]
- The hedging instrument must be designated and effective as an economic hedge of the net investment. [815-20-25-26(e), 830-20-35-3]

See chapter 12 of KPMG Handbook, Derivatives and hedging, for a discussion on net investment hedges.

Question 7.4.160

Are foreign currency gains and losses on intra-entity transactions recognized in the consolidated financial statements?

Interpretive response: Generally, yes. Intra-entity foreign currency transactions affect functional currency cash flows and are accounted for like foreign currency transactions with outside parties – i.e. foreign currency transaction gains and losses are included in consolidated net income.

The only exception relates to transactions that are of a long-term investment nature – i.e. if settlement of the transaction is not planned or anticipated in the foreseeable future. In that case, the resulting foreign currency gain or loss is reported in the same manner as translation adjustments. [830-20-35-3(b), 830-20-35-4]

Section 3 in KPMG Handbook, Foreign currency, discusses how to account for intra-entity foreign currency transactions, and section 4 discusses how to determine whether intra-entity transactions are of a long-term investment nature.

Question 7.4.170

Can a member of the consolidated group hedge intra-entity foreign currency transactions?

Interpretive response: Yes. A member of the consolidated group is permitted to hedge its forecasted intra-entity foreign currency transactions and its intra-entity foreign-currency denominated recognized assets and liabilities. [815-20-25-28]

However, a parent cannot hedge a subsidiary's foreign currency risk if it is not directly exposed to the risk of exchange rate changes on the subsidiary's foreign currency transactions. To apply hedge accounting, the entity with the foreign currency risks needs to be party to the hedging instrument and the hedged transaction needs to be denominated in a currency other than the hedging entity's functional currency. [815-20-25-27, 25-30(b)]

See chapter 11 of KPMG Handbook, Derivatives and hedging, for a discussion of foreign currency hedges.

Question 7.4.180

How does a parent account for an outside basis difference on its investment in a consolidated subsidiary?

Interpretive response: The difference between the financial statement carrying amount and the tax basis of a parent's investment in the stock of a subsidiary is known as an outside basis difference. This may result in a temporary difference even though the investment account is eliminated in the consolidated financial statements.

However, there are certain exceptions to the recognition of deferred taxes for outside basis differences related to investments in subsidiaries. The availability of these exceptions may depend on:

— whether the subsidiary is domestic or foreign;
— the provisions of the applicable tax law;
— the parent company's plans for reinvestment of undistributed earnings of the subsidiary; and
— whether the outside basis difference is taxable or deductible.

Type of subsidiary	Exception to recognition of deferred taxes
Foreign	Deferred tax liability is not recognized for a taxable outside basis difference if: [740-30-25-17] — the taxable outside basis difference meets the indefinite reversal criterion; or — the parent has the ability to recover the reported amount of its investment in a tax-free manner and intends to do so. Deferred tax asset is not recognized for a deductible outside basis difference unless it is apparent that the temporary difference will reverse in the foreseeable future. [740-30-25-9]
Domestic	Deferred tax liability is not recognized for a taxable outside basis difference if both of the following are true: [740-30-25-7 – 25-8] — the tax law provides a means for the parent entity to recover the reported amount of that investment in a tax-free transaction; and — the parent entity expects it will ultimately use that means.

Type of subsidiary	Exception to recognition of deferred taxes
	Deferred tax asset is not recognized for a deductible outside basis difference unless it is apparent that the temporary difference will reverse in the foreseeable future. [740-30-25-9]

These exceptions do not generally apply to investments in partnerships (or other pass-through entities) or equity method investees.

See section 2 of KPMG Handbook, Accounting for income taxes, for a discussion on identifying temporary differences, and section 7 for a discussion on foreign operations.

Question 7.4.190

How are the tax effects of intra-entity transactions accounted for in the consolidated financial statements?

Interpretive response: The tax effects of an intra-entity transaction are not eliminated in consolidation unless the transaction is the sale of inventory (see below).

Although intra-entity balances and transactions are eliminated in consolidation, they typically are taxable events with economic consequences outside the consolidated group. For example, an intra-entity sale or purchase of assets generally results in a taxable gain or loss for the seller in its tax jurisdiction and establishes a new tax basis for the assets in the buyer's tax jurisdiction.

Both the seller and the buyer in an intra-entity transaction are required to immediately recognize the current and deferred income tax consequences of the transaction. The consolidated financial statements should reflect the full tax effects of intra-entity transactions (except sales of inventory). Those effects may involve recognizing:

- current taxes on the transaction;
- the reversal of the seller's existing deferred taxes related to any assets sold or liabilities settled;
- the establishment of the buyer's new deferred taxes related to assets purchased or liabilities issued; and
- deferred taxes on any changes to the parent's outside basis difference in its investment in the subsidiary.

Intra-entity inventory sales

The net tax effect of an intra-entity transfer of inventory is deferred in consolidation as long as the inventory remains in the consolidated group. [740-10-25-3(e), 810-10-45-8]

We believe that for the inventory exception to apply, the transferred asset must be inventory for both the buyer and the seller.

See section 2 of KPMG Handbook, Accounting for income taxes, for an additional discussion of accounting for the tax effect of intra-entity transactions.

7.5 NCI

7.5.10 Attribution of comprehensive income

Excerpt from ASC 810-10

General

> Attributing Net Income and Comprehensive Income to the Parent and the Noncontrolling Interest

45-18 The amount of intra-entity income or loss to be eliminated in accordance with paragraph 810-10-45-1 is not affected by the existence of a noncontrolling interest. The complete elimination of the intra-entity income or loss is consistent with the underlying assumption that consolidated financial statements represent the financial position and operating results of a single economic entity. The elimination of the intra-entity income or loss may be allocated between the parent and noncontrolling interests.

45-19 Revenues, expenses, gains, losses, net income or loss, and other comprehensive income shall be reported in the consolidated financial statements at the consolidated amounts, which include the amounts attributable to the owners of the parent and the noncontrolling interest.

45-20 Net income or loss and comprehensive income or loss, as described in Topic 220, shall be attributed to the parent and the noncontrolling interest.

45-21 Losses attributable to the parent and the noncontrolling interest in a subsidiary may exceed their interests in the subsidiary's equity. The excess, and any further losses attributable to the parent and the noncontrolling interest, shall be attributed to those interests. That is, the noncontrolling interest shall continue to be attributed its share of losses even if that attribution results in a deficit noncontrolling interest balance.

> Redemption of a Subsidiary's Redeemable Stock

40-1 Accounting for the purchase (early extinguishment) of a wholly owned **subsidiary's** mandatorily redeemable preferred stock, including stock that contains a redemption feature but is not considered a mandatorily redeemable financial instrument under Topic 480, differs dependent on whether the preferred stock is required under Topic 480 to be accounted for as a liability.

>> Mandatorily Redeemable Preferred Stock Accounted for as a Liability

40-2A Section 480-10-25 requires mandatorily redeemable preferred stock to be accounted for as a liability under certain conditions. If mandatorily redeemable preferred stock is accounted for as a liability, then any amounts paid or to be paid to holders of those contracts in excess of the initial measurement amount are reflected as interest cost and not as **noncontrolling interest** charge. Topic 860 specifies whether a liability has been extinguished and Subtopic 470-50 requires that the **parent** recognize a gain or loss upon extinguishment of the subsidiary's liability for mandatorily redeemable preferred shares for any difference between the carrying amount and the redemption amount.

Excerpt from ASC 830-30

> Translation of Foreign Currency Statements

>> Cumulative Translation Adjustments Attributable to Noncontrolling Interests

45-17 Accumulated translation adjustments attributable to noncontrolling interests shall be allocated to and reported as part of the noncontrolling interest in the consolidated reporting entity.

When preparing consolidated financial statements, the subsidiary's comprehensive income is attributed to the parent and NCI. Subtopic 810-10 provides little detailed guidance for this attribution. However, it is explicit that losses attributable to the parent and NCI may exceed their equity interests in the subsidiary, and in some instances may result in a deficit NCI balance. [810-10-45-20 – 45-21]

Intra-entity balances and transactions are fully eliminated (see section 7.4.10). Full elimination is required regardless of whether NCI exists because consolidated financial statements are presented as if the consolidated group is a single economic entity. The elimination of intra-entity profit or loss (and OCI) may be attributed to the parent and the NCI, except when the subsidiary is a VIE. [810-10-45-18 – 45-19]

Translation adjustments (and other components of OCI) that relate to NCI are allocated to and reported as part of NCI in the consolidated financial statements. [830-30-45-17]

This section addresses attribution of comprehensive income to NCI under Subtopic 810-10. Section 480-10-S99 provides incremental guidance about how to account for redeemable NCI that is presented in temporary equity (see section 7.5.20).

Question 7.5.10

If comprehensive income is not attributed solely based on ownership interests, what attribution method is used?

Background: Subtopic 810-10 provides general guidance for attributing comprehensive income to the parent and NCI. However, the Subtopic does not prescribe a specific attribution method for complex circumstances. When a partially owned subsidiary's contractual arrangements do not attribute comprehensive income solely based on ownership interests, questions may arise as to the appropriate attribution method to use.

The hypothetical liquidation at book value ('HLBV') method was discussed in the AICPA's Proposed SOP, Accounting for Investors' Interests in Unconsolidated Real Estate Investments, in the context of applying the equity method. Under the HLBV method, an equity method investor determines its share of an investee's comprehensive income by comparing its claim on the investee's book value at the beginning and end of the period, assuming the investee were to liquidate all assets at their US GAAP amounts and distribute the resulting cash to creditors and investors under their respective priorities. The proposed SOP was never issued; however, the HLBV method is commonly used in practice by equity method investors and parent companies when an investee's capital structure gives them different rights and priorities from their ownership interests. This situation is common in a number of structures where distributions are made pursuant to contractual waterfall provisions.

See section 4.3 of KPMG Handbook, Equity method of accounting, for additional discussion.

Interpretive response: When a subsidiary's contractual arrangements provide for the allocation and distribution of comprehensive income proportionally based on ownership interests, we believe the attribution is straightforward and should be based on the ownership interests. [810-10-45-20]

The allocation and distribution of comprehensive income is not straightforward when a substantive profit-sharing arrangement exists – or other contractual arrangement in which the owners' economic rights differ from their legal ownership interests in the entity. In this situation, we believe the parent should attribute the partially owned subsidiary's comprehensive income based on the parties' rights to the distributions and residual assets of the subsidiary under that arrangement.

For example, if the specified allocation for comprehensive income differs from the allocation of cash from operations and on liquidation, the parent should not use the specified percentages to attribute the subsidiary's comprehensive income. Instead, the parent should analyze the profit-sharing arrangement to determine how the increase or decrease in the subsidiary's net assets during the reporting period would affect the cash that the parties would receive over the subsidiary's life and on its liquidation.

To achieve this attribution, we believe one acceptable method may be the HLBV method. Under HLBV, the parent computes at the beginning and end of the reporting period each party's share of the subsidiary's net assets assuming the subsidiary (1) liquidated its net assets at their book values and (2) distributed the proceeds to the interest holders based on the distribution waterfall in the profit-sharing arrangement. A party's share of the subsidiary's comprehensive income is the change in its share of the subsidiary's net assets from the beginning to the end of the reporting period (after adjusting for cash contributions and distributions).

If there is uncertainty about how cash would ultimately be distributed, the parent needs to consider the facts and circumstances and use judgment when determining which attribution method best reflects the economic substance of the arrangement. An example of such uncertainty is when attribution could change based on the resolution of a contingency.

We believe a parent using the HLBV method should generally disclose the terms of the arrangements and how it determined the attribution between the parent and NCI.

Example 7.5.10

Attributing subsidiary comprehensive income with a profit-sharing arrangement

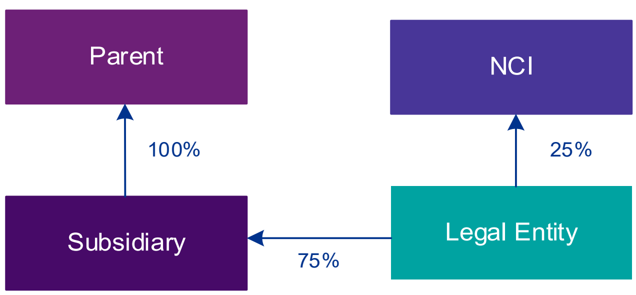
Background

Parent acquired 100% of the ownership interests of Subsidiary in a single transaction on January 1, Year 1. The transaction was a business combination accounted for under Topic 805.

Subsidiary holds a 75% ownership interest in Legal Entity. Legal Entity's partnership agreement attributes net income (or loss) to Subsidiary and NCI based on a profit-sharing arrangement.

For the year ended December 31, Year 1, Legal Entity has net income of $2,000. Under the profit-sharing arrangement, Legal Entity attributes 80% of its net income to Subsidiary and 20% to NCI.

Assume that these attribution percentages apply at all income levels throughout Legal Entity's limited life.



Assume that push-down accounting of Parent's basis was not elected in Legal Entity's separate financial statements. Parent's consolidated financial statements reflect an adjustment of $800 for additional depreciation expense related to its fair value adjustments to the net assets of Legal Entity in acquisition accounting.

Evaluation

For the year ended December 31, Year 1, Parent determines the amount of the net income attributable to NCI in its consolidated financial statements based on the terms of the profit-sharing arrangement.

	Legal Entity	Parent
Legal Entity reported net income	$2,000	$2,000
Depreciation adjustment for basis step-up at acquisition	---	(800)
Adjusted net income	$2,000	$1,200
Attribution of net income:		
Parent	$1,600[1]	$960[3]
NCI	$400[2]	$240[4]

Notes:

1. $2,000 × 80% = $1,600
2. $2,000 × 20% = $ 400
3. $1,200 × 80% = $ 960
4. $1,200 × 20% = $ 240

Question 7.5.15

How does a parent account for the acquisition-date difference between fair value and liquidation value of NCI when it expects to use HLBV?

Background: The acquirer in a business combination generally recognizes and measures NCI at its acquisition-date fair value (see Question 7.2.10).

After the acquisition, the parent attributes the subsidiary's comprehensive income between its interest and NCI. When a subsidiary's contractual arrangements provide for the allocation and distribution of comprehensive income proportionally based on ownership interests, we believe the attribution is straightforward and should be based on the ownership interests.

When a partially owned subsidiary's contractual arrangements do not attribute comprehensive income solely based on ownership interests, we believe the parent should attribute the partially owned subsidiary's comprehensive income based on the parties' rights to the distributions and residual assets of the subsidiary under that arrangement. To achieve this attribution, we believe one acceptable method may be the HLBV method (see Question 7.5.10).

Under HLBV, the parent computes at the beginning and end of the reporting period each party's share of the subsidiary's net assets assuming the subsidiary (1) liquidated its net assets at their book values and (2) distributed the proceeds to the interest holders based on the distribution waterfall in the profit-sharing arrangement.

Sometimes there is a difference at the acquisition date between the liquidation amount attributable to the NCI holder(s) under HLBV and the fair value of the NCI. A question arises about the accounting for this difference because the liquidation amount attributable to the NCI holder(s) at the acquisition date serves as the starting point for computing the amount of comprehensive income to attribute to NCI in the first reporting period following the acquisition.

Interpretive response: We believe the parent should not recognize this difference at the acquisition date. Instead, the parent:

— measures NCI at its acquisition-date fair value; and
— uses the acquisition-date liquidation value as the beginning of period amount in its HLBV computation.

Using this approach may result in a gain or loss on acquisition of the NCI or liquidation of the subsidiary.

There may be other acceptable approaches based on the facts and circumstances. For example, it may be acceptable to recognize the difference over time, depending on the nature of the underlying asset(s) or liability (liabilities) that gave rise to the difference.

Question 7.5.16
How is NCI adjusted on the distribution of investment tax credits when HLBV is applied?

Background: In the United States, renewable solar and wind projects may be eligible for investment tax credits (ITCs). The ITCs are received by the owner of the project when commercial operations commence.

The amount of ITCs is typically based on a specified percentage of the cost of the assets and may be used to offset the owner's federal income tax liability, subject to certain limitations under the tax law.

The owner may monetize the benefits by identifying another party (a 'tax equity investor') to invest in the project primarily to take advantage of the tax benefits.

Because ITCs are generally nontransferable, the owner (now sponsor) often establishes a controlled limited partnership (or similar structure) and issues noncontrolling equity interests to the tax equity investor. The limited partnership:

- owns and develops the property;
- claims the ITCs when eligible;
- distributes the ITCs in accordance with the governing documents; and
- operates the property on an ongoing basis to avoid recapture of the ITCs under tax law.

ITCs may be subject to recapture if, for example, the partnership is liquidated before the credits fully vest under specified tax law. Recapture creates a tax liability for the investor that received the tax credits, generally the tax equity investor. Some governing documents explicitly require the sponsor to restore the tax equity investor's capital account if the ITCs are recaptured on liquidation of the partnership. Other agreements may guarantee the tax equity investor's internal rate of return (IRR), but do not specifically address the sponsor's obligations on liquidation of the partnership and recapture of the ITCs.

Sponsors often use the HLBV method as the basis for attributing the partnership's comprehensive income between its controlling interest and the tax equity investor's NCI (see Question 7.5.10). This is because the partnership agreement generally includes complex provisions for allocating profits and losses, liquidation proceeds and tax attributes.

Interpretive response: We understand there is diversity in practice on this issue and there may be a variety of acceptable approaches depending on individual facts and circumstances.

However, we believe there are two primary methods used to adjust NCI on the distribution of ITCs to the NCI holder when HLBV is applied.

- Method 1: Adjust NCI immediately on distribution of ITCs.
- Method 2: Adjust NCI as ITCs vest.

Method 1: Adjust NCI immediately on distribution of ITCs

On distribution of the ITCs to the NCI holder(s), a sponsor that applies Method 1 adjusts NCI. This immediate decrease in NCI results in a corresponding increase to net income attributed to the controlling interest.

Application of HLBV involves assuming that the net assets of the partnership are liquidated at their book values and distributed to the investors based on the distribution waterfall in the governing documents. Under the governing documents, the distribution of the ITCs to the NCI holder(s) reduces the NCI holder(s) capital account. The immediate decrease in NCI reflects this reduction.

This treatment disregards the scenario in which some or all of the ITCs are recaptured, and the tax equity investor's capital account is restored by the sponsor. We believe disregarding this scenario is appropriate if any one of the following three conditions exists.

- There is no provision in the governing documents to reallocate the capital accounts in the event of recapture.
- There is a provision in the governing documents to reallocate the capital accounts in the event of recapture, but it is not substantive (see discussion below).
- ITC recapture has a remote likelihood of occurring. Remote is defined in Topic 450 as the chance of the future event or events occurring being slight. [450-20 Glossary]

In most situations, one of the above conditions exists and we believe the application of Method 1 would be reasonable. However, we believe the sponsor may apply Method 2 – adjust NCI during the recapture period as the ITCs vest (and therefore are no longer subject to recapture) – if the first of the following conditions exists, and should apply Method 2 if both of the following conditions exist:

- there is a substantive provision in the governing documents to reallocate the capital accounts in the event of ITC recapture; and
- ITC recapture has a more than remote likelihood of occurring.

We believe the sponsor should apply Method 2 when both conditions exist because it would generally not be appropriate to ignore a substantive clause that has a reasonable likelihood of impacting the distribution of cash flows.

Method 2: Adjust NCI as ITCs vest

Under Method 2, the sponsor adjusts NCI (and therefore recognizes the increase to net income attributed to the controlling interest) during the recapture period as the credits vest (and therefore are no longer subject to recapture). This results in an annual adjustment to NCI (and therefore recognition of the increase to net income attributed to the controlling interest) on the date the recapture provision expires under tax law. Because recapture provisions generally lapse in a nonlinear fashion, the NCI adjustment is not expected to be ratable over quarterly reporting periods.

When ITC recapture has a remote likelihood of occurring, we believe electing to apply this method is appropriate only if the governing documents include a provision that requires the sponsor to restore the tax equity investor's capital account if the ITCs are recaptured on liquidation of the partnership. To conclude that such a requirement is substantive, we believe it should have priority over other allocation provisions in the governing documents (e.g. a sponsor's guarantee of the tax equity investor's IRR) in the event of liquidation and recapture.

Selecting a method

The selection of the appropriate method may require judgment depending on the facts and circumstances. When eligible for both approaches, a sponsor's decision about whether to apply Method 1 or Method 2 is an accounting policy election that must be consistently applied to similar arrangements. See section 3.3 in KPMG Handbook, Accounting changes and error corrections, for additional guidance on voluntary changes in accounting policy.

As discussed above, we understand there is diversity in practice on this issue and there may be other acceptable approaches depending on individual facts and circumstances. However, in general we do not believe it is appropriate for the sponsor to adjust NCI over the:

— asset's depreciable life for tax purposes;
— period the NCI holder(s) expects to hold its investment; or
— period the tax equity investor is expected to achieve the specified IRR.

Selection of the appropriate method to adjust NCI on the distribution of ITCs to the NCI holder when HLBV is applied is one of the many judgments involved in the application of HLBV.

Question 7.5.20

How is net income attributed to preferred NCI that is entitled to dividends?

Background: A subsidiary may have both common and preferred stock. The common and preferred shares that are not held by the parent are NCI in the consolidated financial statements. Preferred stock is often entitled to a fixed dividend that accrues each period.

Interpretive response: In the consolidated financial statements, a parent accrues dividends on a subsidiary's preferred stock through attribution of subsidiary income to NCI. This is the case even if the subsidiary is reporting a net loss – i.e. the accrued dividend reduces subsidiary net income attributable to parent or increases subsidiary net loss attributable to parent. [810-10-40-2]

Question 7.5.30

How is subsidiary net income attributed to an NCI that has a liquidation preference?

Background: A subsidiary may have both common and preferred stock. The common and preferred shares that are not held by the parent are NCI in the consolidated financial statements. Unlike common stock, preferred stock is generally entitled to a liquidation preference consisting of the par amount and/or cumulative unpaid dividends – i.e. it ordinarily does not have the characteristics of a residual equity interest in the subsidiary.

Interpretive response: We believe a subsidiary's net income (or loss) is first attributed to a preferred stock NCI based on its stated dividend and liquidation rights (see Question 7.5.20). Losses are not generally attributed to those NCI because they do not represent a residual interest in the subsidiary. As a result, these NCI are reported at their liquidation amount – unless a substantive profit-sharing arrangement exists that suggests settlement at a lesser amount (see Question 7.5.10). [810-10-45-21]

NCI that are legal-form common stock are generally allocated both earnings and losses because they represent a residual interest in the subsidiary. Losses are attributed to common stock NCI even if they have been reduced to zero.

However, the parent should carefully evaluate the terms of the stock before reaching a conclusion as to whether to allocate losses to NCI; this is because certain preferred shares do not have a liquidation preference, and certain common shares do. We believe the conclusion about whether to attribute losses to NCI depends on whether the interest is a residual interest in the subsidiary. Therefore, if preferred shares represent a residual equity interest, we believe it is appropriate to attribute losses to the NCI because the shares have the characteristics of common stock.

Question 7.5.40

Is NCI adjusted when a liquidation preference expires?

Background: As discussed in Question 7.5.30, an NCI with a liquidation preference is generally reported at its liquidation amount. There are some circumstances in which the liquidation preference expires – e.g. after a stated period and/or on the occurrence (or nonoccurrence) of specified events.

Interpretive response: No. We believe a parent does not reverse any changes to the NCI's carrying amount that were recognized as a result of the liquidation preference.

This treatment is consistent with how a parent accounts for redeemable NCI that is reclassified from temporary equity to permanent equity under Section 480-10-S99. Although redeemable NCI and NCI with a liquidation preference are not the same, we believe the same guidance applies because both are:

— equity in legal form; and
— subject to specialized measurement because they lack the attributes characteristic of a residual interest in the subsidiary.

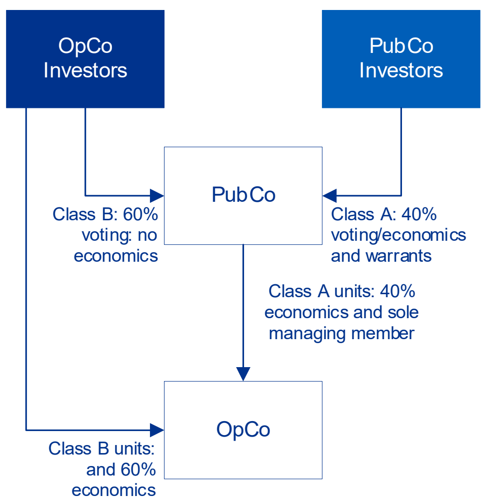
Some or all of the amounts that were recognized as a result of the liquidation preference will be reversed if the parent increases its ownership percentage or the subsidiary is deconsolidated (see Question 7.5.180).

Question 7.5.45

Does a parent in an Up-C structure attribute income or expense from parent's liability classified warrants to NCI holders when there is a reciprocal arrangement with the subsidiary?

Background: A public company (PubCo) that is a special-purpose acquisition company (SPAC) merged with a privately held operating company (OpCo). To effect the merger, the entities were reorganized into an umbrella partnership C Corporation (Up-C) structure, where PubCo became the managing member in OpCo and obtained a controlling financial interest. The pre-merger owners of OpCo were issued Class B shares of PubCo and retained an NCI in OpCo through Class B units.

PubCo had issued warrants for its Class A common stock (Upstairs Warrants) that are classified as liabilities under Subtopic 815-40, with changes in fair value of the liability-classified warrants reported in earnings. The following illustrates the post-merger ownership structure.



The operating agreement of OpCo contains a 'reciprocal arrangement'. This arrangement requires OpCo to issue Class A units to PubCo that equal the number of Class A shares issued by PubCo when the Upstairs Warrants are exercised. PubCo is required to contribute the proceeds to OpCo.

PubCo's only assets are the investment in OpCo; all of the consolidated group's operations are conducted at the OpCo level.

The unique nature of the structure and reciprocal arrangement raises questions about whether to attribute the income or expense from the change in the fair value of the warrants to the NCI holders and parent or solely to the parent.

Interpretive response: We understand there is diversity in practice and believe the parent may make a policy election in an arrangement like that described in the background. Topic 810 does not prescribe specific guidance on how to allocate a subsidiary's income to NCI other than to state that losses attributed to the parent and NCI may exceed their equity balances in the subsidiary. [810-10-45-21]

Given the lack of prescriptive guidance, we believe the parent (PubCo) in the background example may apply either of the following approaches to attribute the income or expense from the change in fair value of the warrants.

Approach 1: Attribute to NCI holders and parent

Under this approach, the income or expense is attributed to NCI holders of OpCo and PubCo consistent with the income of the subsidiary (see Question 7.5.10). We believe this approach is acceptable because the liability-classified warrants effectively represent an obligation of OpCo as follows:

— all of the operations are at the OpCo level and any obligation of PubCo would in substance be settled through the assets of OpCo; and
— the reciprocal arrangement creates a corresponding obligation of OpCo.

Approach 2: Attribute entirely to parent

Under this approach, the entire amount is attributable to PubCo because the warrant liability is a legal obligation and US GAAP does not require the income or expense to be recorded in the financial statements of the subsidiary. Therefore, we believe it is acceptable to treat the income or expense as that of the parent and not the subsidiary.

Question 7.5.50

Does an NCI holder recognize a liability in its separate financial statements if its interest is a deficit balance in the consolidated financial statements?

Interpretive response: Generally, no. Although attribution of subsidiary losses can result in a deficit balance for NCI under Subtopic 810-10, an NCI holder applies other US GAAP to its investment, which may not permit or require recognition of a liability. [810-10-45-21]

For example, if the NCI holder accounts for its investment in the subsidiary using the equity method under Topic 323, it does not reduce its investment balance below zero unless it has an obligation to fund losses. See section 4.4.20 of KPMG Handbook, Equity method of accounting, for additional discussion. [323-10-35-19 – 35-22]

Question 7.5.60

How are a VIE's losses that exceed the VIE's US GAAP equity attributed in consolidation?

Background: To fund its operations, a VIE may issue limited recourse notes that provide for payment solely from the VIE's operations. These in-form debt instruments may be designed to absorb any losses that exceed the VIE's total US GAAP equity.

Interpretive response: After initial measurement, the primary beneficiary generally accounts for the assets, liabilities and NCI of a consolidated VIE as if the VIE was consolidated based on voting interests. [810-10-35-3]

As a result, the primary beneficiary first applies other US GAAP to the VIE's operations, including the guidance in Topic 480 to account for the debt instrument. After it arrives at the VIE's net loss, the primary beneficiary attributes that net loss to the VIE's NCI – i.e. any equity interests that are not held by the primary beneficiary. This continues even if the recognition and attribution of net loss results in a deficit balance in the VIE's equity. All net losses of the VIE are attributed to the VIE's NCI holder(s), with the residual attributed to the primary beneficiary – i.e. net losses are not attributed to non-equity variable interest holders after those interests have been appropriately accounted for in determining the VIE's net loss. [810-10-45-21]

Question 7.5.70

Does the primary beneficiary attribute any of a VIE's net losses to another party if the VIE has no US GAAP equity?

Background: A VIE may be established with no US GAAP equity interests. For example, this may be the case when VIE is established to issue beneficial interests to entirely fund the acquisition of one or more assets.

Interpretive response: No. As discussed in Question 7.5.60, the primary beneficiary first applies other US GAAP to the VIE's operations. This includes accounting for the beneficial interests.

After it arrives at the VIE's net loss, the primary beneficiary attributes that net loss to the VIE's NCI – i.e. any **equity** interests that are not held by the primary beneficiary. None of the VIE's net income or loss is attributed to other parties if the VIE has no US GAAP equity. In this case, the primary beneficiary recognizes all of the profits and losses for the period that it is the primary beneficiary.

Although the primary beneficiary does not attribute any portion of the VIE's net income or loss to the beneficial interest holders, the application of other US GAAP to those interests may ultimately result in similar amounts being attributed to the primary beneficiary. For example, many beneficial interests contain embedded derivatives. If bifurcated and separated, the accounting for the embedded derivatives at fair value under Topic 815 will affect the VIE's net income in much the same way as attributing some of the VIE's net income or loss to the beneficial interest holders based on their share of the total beneficial interests in the VIE.

Question 7.5.80

Does attributing intra-entity eliminations to NCI differ depending on whether the subsidiary is a VIE or a VOE?

Interpretive response: Yes. As discussed in Question 7.4.100, the effect of intra-entity eliminations must be attributed solely to the primary beneficiary when the subsidiary is a VIE. To do so, the amount attributable to NCI is generally calculated using the subsidiary's pre-elimination net income. [810-10-35-3]

When the subsidiary is a VOE, the effect of intra-entity eliminations may be attributed to the parent and NCI. To do so, the amount attributable to NCI is generally calculated using the subsidiary's post-elimination net income. [810-10-45-18]

We recognize that the use of 'may' in the Codification stops short of requiring the intra-entity eliminations to be attributed to both the parent and NCI when the entity is a VOE. We believe a parent's attribution policy should be consistent with the rights and priorities of the parent versus the NCI.

Example 7.4.20 illustrates intra-entity elimination entries if there is no NCI. Examples 7.5.10 through 7.5.30 illustrate the difference in attributing to NCI intra-entity eliminations when the subsidiary is a VOE versus a VIE.

Example 7.5.20

Attributing intra-entity eliminations to NCI – upstream sale of inventory

Background

Subsidiary sells inventory with a cost of $105,000 to Parent for $150,000, resulting in intra-entity profit of $45,000. Parent owns 75% of Subsidiary's common stock.

At the end of the Year 1, Parent has $30,000 (20%) of the acquired inventory on hand. Subsidiary's intra-entity profit related to Parent's remaining inventory is $9,000 ($45,000 × 20%).

During Year 2, Parent sells the remaining $30,000 of inventory.

There were no other intra-entity transactions in Year 1 or Year 2.

This example ignores income tax effects.

Scenario 1: Subsidiary is a VOE

Year 1 consolidating entries

The following table shows how Parent prepares its consolidation of Subsidiary at the end of Year 1.

	Parent	Subsidiary	Consolidating entries		Consolidated
			Debit	Credit	
Income statement					
Sales	$ 500,000	$ 240,000			$ 740,000
COGS[2]	(300,000)	(130,000)		$ 36,000	(394,000)
Expenses	(190,000)	(90,000)			(280,000)
Intra-entity sales[2]		150,000	$ 150,000		—
Intra-entity COGS[2]		(105,000)		105,000	—
Net income	$ 10,000	$ 65,000	$ 150,000	$ 141,000	$ 66,000
NCI share of income[3]					$ 14,000
Parent's share of net income					$ 52,000
Balance sheet					
Cash	$ 65,000	$ 11,000			$ 76,000
Accounts receivable:	110,000	37,000			147,000
Inventory:					
From vendors	155,000	105,000	$ 21,000		281,000
From Subsidiary[2]	30,000			30,000	----
Investment in Subsidiary[1]	75,000			75,000	----
PP&E (net)	350,000	125,000			475,000
Total assets	$785,000	$278,000	$ 21,000	$105,000	$ 979,000
Liabilities	$405,000	$113,000			$ 518,000
NCI[1, 4]				$ 39,000	39,000
Common stock[1]	250,000	100,000	$100,000		250,000
Retained earnings[2, 4]	130,000	65,000	23,000		172,000
Total liabilities and equity	$785,000	$278,000	$ 123,000	$ 39,000	$ 979,000

Notes:

1. Elimination of Parent's investment in Subsidiary ($75,000), establishment of NCI ($25,000) and elimination of Subsidiary's common stock ($100,000).
2. Full elimination of $45,000 of intra-entity profit from intra-entity sales ($150,000) and COGS ($105,000), recognition of inventory on hand at the end of Year 1 ($21,000 = $30,000 - $9,000), and reclassification to COGS on inventory sold to third parties ($36,000 = (80% × ($150,000 - $105,000)).
3. Noncontrolling share of Subsidiary net income: ($65,000 - $9,000) × 25% = $14,000.
4. Allocation of Subsidiary net income to NCI ($14,000).

Rollforward of consolidated retained earnings attributable to Parent	
Parent – beginning of Year 1	$ 120,000
Parent net income	10,000
Subsidiary net income	65,000
Elimination of intra-entity profit	(9,000)
Attribution to NCI	(14,000)
Retained earnings – end of Year 1	$ 172,000

Year 2 consolidating entries

The following table shows how Parent prepares its consolidation of Subsidiary at the end of Year 2. This table assumes Parent reversed its Year 1 consolidating entries at the beginning of Year 2.

	Parent	Subsidiary	Consolidating entries		Consolidated
			Debit	Credit	
Income statement					
Sales	$ 710,000	$ 240,000			$ 950,000
COGS[3]	(350,000)	(130,000)		$ 9,000	(471,000)
Expenses	(210,000)	(90,000)			(300,000)
Intra-entity sales					—
Intra-entity COGS					—
Net income	$ 150,000	$ 20,000		$ 9,000	$ 179,000
NCI share of income[4]					$ 7,250
Parent's share of net income					$ 171,750
Balance sheet					
Cash	$ 65,000	$ 11,000			$ 76,000
Accounts receivable:	110,000	37,000			147,000
Inventory:					
From vendors	155,000	105,000			260,000
From Subsidiary	—				----
Investment in Subsidiary[1]	75,000			75,000	----
PP&E (net)	400,000	145,000			545,000
Total assets	$805,000	$298,000		$ 75,000	$1,028,000
Liabilities	$275,000	$113,000			$ 388,000
NCI[1, 2, 5]				$ 46,250	46,000
Common stock[1]	250,000	100,000	$100,000		250,000
Retained earnings[2, 5]	280,000	85,000	21,250		343,750
Total liabilities and equity	$805,000	$298,000	$ 121,250	$ 46,250	$1,028,000

Notes:

1. Elimination of Parent's investment in Subsidiary ($75,000), establishment of NCI ($25,000) and elimination of Subsidiary common stock ($100,000).
2. NCI share of Year 1 net income ($14,000).
3. Recognition of Year 1 eliminated profit ($9,000).
4. Noncontrolling share of Subsidiary net income: (20,000 + 9,000) × 25% = $7,250.
5. Allocation of Subsidiary Year 2 net income to NCI ($7,250).

Rollforward of consolidated retained earnings attributable to Parent	
Parent (beginning balance, before eliminations)	$ 130,000[1]
Subsidiary (beginning balance, before eliminations)	65,000[2]
Parent net income	150,000

Subsidiary net income	20,000
Elimination of intra-entity profit – Year 1	(9,000)
Attribution to NCI – Year 1	(14,000)
Year 2 recognition of profit eliminated from Year 1	9,000
Attribution to NCI – Year 2	(7,250)
Retained earnings – end of Year 2	$343,750

Notes:
1. $280,000 retained earnings less $150,000 net income.
2. $85,000 retained earnings less $20,000 net income.

Scenario 2: Subsidiary is a VIE

If Subsidiary is a VIE, the income attributable to NCI is calculated before any eliminations.

— Year 1: $65,000 × 25% = $16,250
— Year 2: $20,000 × 25% = $5,000

Net income attributable to Parent is:

— Year 1: (65,000 × 75%) - 9,000 = $39,750
— Year 2: 20X2: (20,000 × 75%) + 9,000 = $24,000

Comparison of Scenario 1 and Scenario 2

A comparison of Subsidiary's net income allocated between Parent and NCI if Subsidiary is a VOE versus a VIE is summarized below. Although this example shows the attribution of elimination entries to NCI for an upstream sale, the attribution to NCI would be the same in a downstream sale, assuming all other facts in the scenarios were the same.

	Subsidiary is a VOE		Subsidiary is a VIE	
	To Parent	To NCI	To Parent	To NCI
Year 1	$42,000	$14,000	$39,750	$16,250
Year 2	$21,750	$ 7,250	$24,000	$ 5,000

Example 7.5.30
Attributing intra-entity eliminations to NCI – VIE vs VOE subsidiary (intra-entity fees)

Background

Legal Entity has two investors, Investor1 and Investor2. Investor1 has a 40% economic interest in Legal Entity and Investor2 has a 60% economic interest. Investor1 has a controlling financial interest in Legal Entity.

In Year 1, Legal Entity purchases services from Investor1 for $25,000. There are no other intra-entity transactions between Investor1 and Legal Entity. Legal Entity has net income of $100,000 for Year 1.

Scenario 1: Legal Entity is a VIE

All of the elimination of the intra-entity fees is attributed to Investor1 (the primary beneficiary). Investor1's attribution of Legal Entity's net income (after eliminating the intra-entity fees) is computed as follows.

Legal Entity net income	$ 100,000
Investor1's economic interest	× 40%
Attribution to Investor1 before eliminations	40,000
Elimination of intra-entity fees	25,000
Attribution to Investor1	$ 65,000

Investor2's attribution of Legal Entity's net income is computed as follows.

Legal Entity net income	$ 100,000
Investor2's economic interest	× 60%
Attribution to Investor2	$ 60,000

In the consolidated financial statements, Investor1 eliminates the entire $25,000 received from Legal Entity and attributes none of the elimination to NCI. As a result, it reports in NCI $60,000 of Legal Entity's $125,000 of post-elimination net income.

Scenario 2: Legal Entity is a VOE

The elimination of the intra-entity fees may be allocated to Investor1 and Investor2.

Using a proportionate approach to attribute the elimination, Investor1's attribution of Legal Entity's net income (after eliminating the intra-entity fees) is computed as follows.

Legal Entity net income (before eliminations)	$ 100,000
Elimination of intra-entity fees	25,000
Legal Entity net income (after eliminations)	125,000
Investor1's economic interest	× 40%
Attribution to Investor1	$ 50,000

Investor2's attribution of Legal Entity's net income is computed as follows.

Legal Entity net income (before eliminations)	$ 100,000
Elimination of intra-entity fees	25,000
Legal Entity net income (after eliminations)	125,000

Investor2's economic interest	× 60%
Attribution to Investor2	$ 75,000

In the consolidated financial statements, Investor1 eliminates the entire $25,000 received from Legal Entity and attributes 60% of the elimination to NCI. As a result, it reports in NCI $75,000 of Legal Entity's $125,000 of post-elimination net income.

Example 7.5.40

Attributing intra-entity eliminations to NCI – VIE vs VOE subsidiary (intra-entity interest)

Background

At formation in Year 1, Legal Entity was capitalized with a $100 equity investment from Enterprise and a $5,000 loan from Fund. Fund has a controlling financial interest in Legal Entity.

During Year1, Fund recognizes $500 of interest income on the loan. The loan is the only intra-entity transaction between Legal Entity and Fund.

Scenario 1: Legal Entity is a VOE

	Fund	Legal Entity	Consolidating entries	Consolidated Fund
Revenues	$10,000	$2,500	–	$12,500
Cost of sales	8,000	1,500	–	9,500
Margin	2,000	1,000	–	3,000
Other				
Interest income	500	–	(500)	–
Interest expense	–	500	500	–
Net income before NCI	2,500	500	–	3,000
NCI	–	–	(1,000)[1]	(1,000)
Net income after NCI	$2,500	$500	$(1,000)	$2,000

Note:
1. $1,000 post-elimination net income × 100%.

The effect of the eliminating entry on Legal Entity's net income has been attributed entirely to NCI because NCI holds 100% of Legal Entity's equity.

Scenario 2: Legal Entity is a VIE

	Fund	Legal Entity	Consolidating entries	Consolidated Fund
Revenues	$10,000	$2,500	–	$12,500
Cost of sales	8,000	1,500	–	9,500
Margin	2,000	1,000	–	3,000
Other				
Interest income	500	–	(500)	–
Interest expense	–	500	500	–
Net income before NCI	2,500	500	–	3,000
NCI	–	–	(500)[1]	(500)
Net income after NCI	$2,500	$500	$(500)	$2,500

Note:
1. $500 pre-elimination net income × 100%.

The effect of the eliminating entry on Legal Entity's net income has been attributed entirely to Fund because Fund is Legal Entity's primary beneficiary (see Question 7.4.100).

Although Fund's interest income has been eliminated, its consolidated net income remains unchanged at $2,500; Enterprise is legally and economically entitled to only $500 of net income earned by Legal Entity.

Scenario 3: Legal Entity is a VOE (variation)

Fund owns a 60% economic interest and Enterprise owns a 40% economic interest.

	Fund	Legal Entity	Consolidating entries	Consolidated Fund
Revenues	$10,000	$2,500	–	$12,500
Cost of sales	8,000	1,500	–	9,500
Margin	2,000	1,000	–	3,000
Other				
Interest income	500	–	(500)	–
Interest expense	–	500	500	–
Net income before NCI	2,500	500	–	3,000
NCI	–	–	(400)[1]	(400)
Net income after NCI	$2,500	$500	$(400)	$2,600

Note:
1. $1,000 post-elimination net income × 40%.

Scenario 4: Legal Entity is a VIE (variation)

Fund owns a 60% economic interest and Enterprise owns a 40% economic interest.

	Fund	Legal Entity	Consolidating entries	Consolidated Fund
Revenues	$10,000	$2,500	–	$12,500
Cost of sales	8,000	1,500	–	9,500
Margin	2,000	1,000	–	3,000
Other				
Interest income	500	–	(500)	–
Interest expense	–	500	500	–
Net income before NCI	2,500	500	–	3,000
NCI	–	–	(200)[1]	(200)
Net income after NCI	$2,500	$500	$(200)	$2,800

Note:
1. $500 pre-elimination net income × 40%.

Question 7.5.90
How is income tax expense presented in the consolidated financial statements when NCI exists?

Interpretive response: Income tax expense or benefit attributed to both parent and NCI is presented in consolidated income tax expense. Consolidated income tax expense or benefit is deducted from (or added to) consolidated pretax income or loss to arrive at consolidated net income. Net income attributable to NCI is then presented as an allocation of consolidated net income. [810-10-50-1A]

As a result, net income attributable to NCI is presented after tax and the income tax associated with NCI is presented in consolidated income tax expense or benefit.

The components of OCI attributable to the parent and NCI are presented net of tax, or before tax with the aggregate income tax expense or benefit. The amount of income tax expense or benefit allocated to each component of OCI is either presented in the statement of comprehensive income or in the notes to financial statements. [220-10-45-11 – 45-12, 810-10-55-4K]

See section 9 of KPMG Handbook, Accounting for income taxes, for additional discussion.

Example 7.5.50

Financial statement presentation – net income attributed to NCI in a pass-through entity

Background

Parent consolidates Subsidiary in which it has a 90% ownership interest. Parent's statutory tax rate is 21%.

Subsidiary has $100,000 of pretax income.

Scenario 1: Subsidiary is a pass-through entity

Subsidiary is a pass-through entity and is not subject to income taxes in its tax jurisdiction. Taxable income and losses flow through Subsidiary to its owners.

The following amounts are included in Parent's consolidated financial statements.

Revenues	$140,000
Less: Expenses	(40,000)
Income before income tax expense	100,000
Income tax expense	(18,900)[1]
Net income	$ 81,100
Less: Net income attributable to NCI	(10,000)[2]
Net income attributable to controlling interest	$ 71,100

Notes:

1. $90,000 (Parent's 90% share of Subsidiary's $100,000 of net income) × 21% (tax rate). Parent's taxable income includes only its share of Subsidiary's net income. The NCI's tax effects do not affect Parent's consolidated financial statements.
2. $100,000 (Subsidiary's net income) × 10% (NCI ownership interest).

Scenario 2: Subsidiary is a taxable entity

Subsidiary is a taxable entity and reports $21,000 of income tax expense in its separate financial statements.

Revenues	$140,000
Less: Expenses	(40,000)
Income before income tax expense	100,000
Income tax expense	(21,000)[1]
Net income	79,000
Less: Net income attributable to NCI	(7,900)[2]
Net income attributable to controlling interest	$ 71,100

Notes:

1. $100,000 (Subsidiary's net income) × 21% (tax rate). Parent's taxable income includes 100% of Subsidiary's net income.
2. $79,900 (Subsidiary's net income) × 10% (NCI ownership interest).

7.5.20 Changes in redemption value – redeemable NCI

Excerpt from ASC 810-10

General

> Changes in a Parent's Ownership Interest in a Subsidiary

…

45-23 Changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary shall be accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners). Therefore, no gain or loss shall be recognized in consolidated net income or comprehensive income. The carrying amount of the noncontrolling interest shall be adjusted to reflect the change in its ownership interest in the subsidiary. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent. Example 1 (paragraph 810-10-55-4B) illustrates the application of this guidance.

Excerpt from ASC 480-10

> SEC Staff Guidance

>> Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings

>>> SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

…

13. *Subsequent measurement*. The SEC staff's views regarding the subsequent measurement of a redeemable equity instrument that is subject to ASR 268 are included in paragraphs 14–16. Paragraphs 14 and 15 discuss the general views regarding subsequent measurement. Paragraph 16 discusses the application of those general views in the context of certain types of redeemable equity instruments.

14. If an equity instrument subject to ASR 268 is currently redeemable (for example, at the option of the holder), it should be adjusted to its maximum redemption amount at the balance sheet date. If the maximum redemption amount is contingent on an index or other similar variable (for example, the fair value of the equity instrument at the redemption date or a measure based on historical EBITDA), the amount presented in temporary equity should be calculated based on the conditions that exist as of the balance sheet date (for example, the current fair value of the equity instrument or the most recent EBITDA measure). The redemption amount at each balance sheet date should also include amounts representing dividends not currently declared or paid but which will be payable under the redemption features or for which ultimate payment is not solely within the control of the registrant (for example, dividends that will be payable out of future earnings). [FN13]

FN13 See also Section 260-10-45.

15. If an equity instrument subject to ASR 268 is not currently redeemable (for example, a contingency has not been met), subsequent adjustment of the amount presented in temporary equity is unnecessary if it is not probable that the instrument will become redeemable. If it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), the SEC staff will not object to either of the following measurement methods provided the method is applied consistently:

a. Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the instrument will become redeemable, if later) to the earliest redemption date of the instrument using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates.
b. Recognize changes in the redemption value (for example, fair value) immediately as they occur and adjust the carrying amount of the instrument to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the instrument.

16. The following additional guidance is relevant to the application of the SEC staff's views in paragraphs 14 and 15:

a. For share-based payment arrangements with employees, the amount presented in temporary equity at each balance sheet date should be based on the redemption provisions of the instrument and should take into account the proportion of consideration received in the form of employee services (that is, the pattern of recognition of compensation cost pursuant to Topic 718). [FN14]

   FN14 See also the Interpretative Response to Question 2 in Section E of Section 718-10-S99.

b. For employee stock ownership plans where the cash redemption obligation relates only to a market value guarantee feature, the registrant may elect as an accounting policy to present in temporary equity either (i) the entire guaranteed market value amount of the equity securities or (ii) the maximum cash obligation based on the fair value of the underlying equity securities at the balance sheet date.

c. For noncontrolling interests, the adjustment to the carrying amount presented in temporary equity is determined after the attribution of net income or loss of the subsidiary pursuant to Subtopic 810-10.

d. For convertible debt instruments that contain a separately classified equity component, an amount should be presented in temporary equity only if the instrument is currently redeemable or convertible at the balance sheet date for cash or other assets (see paragraph 3(e)). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion at the balance sheet date over (2) the carrying amount of the liability-classified component of the convertible debt instrument at the balance sheet date. [FN15]

FN15 ASR 268 does not impact the application of other applicable GAAP to the accounting for the liability component or the accounting upon derecognition of the liability and/or equity component.

e. For a redeemable equity instrument other than those discussed in (a), (b), and (d) of this paragraph, regardless of the accounting method applied in paragraphs 14 and 15, the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument from the application of paragraphs 14 and 16 are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument from the application of paragraphs 14 and 15.

Redeemable NCI may arise in a number of ways, for a variety of purposes and with widely varying terms. Sometimes, the intent of a redemption feature is to facilitate delivery of all of the shares to the parent at a later date for liquidity, tax or other reasons. Other times, the redemption features represent a protective right granted to the NCI holder(s), or a method for the parent to limit transferability of the NCI.

Redeemable NCI must be presented outside of permanent equity by entities that are subject to SEC reporting requirements and may be presented that way by entities that are not. Temporary equity presentation is generally required for SEC reporting entities if the NCI can redeem its interest for a fixed amount of cash or other assets. See section 8.2.20 for additional discussion of temporary equity presentation. [S-X Rule 5-02.27, 480-10-S99-1]

Redeemable NCI is subsequently adjusted under Section 480-10-S99 based on its redemption amount (if higher) depending on whether the NCI is redeemable currently or in the future. [480-10-S99-3A]

Question 7.5.100
How is redeemable NCI measured in temporary equity?

Interpretive response: Redeemable NCI that is classified as temporary equity (referred to as 'redeemable NCI') is generally initially measured at its fair value (see Question 7.2.140) and is subsequently adjusted for its attribution of the subsidiary's comprehensive income under Subtopic 810-10 (see section 7.5.10).

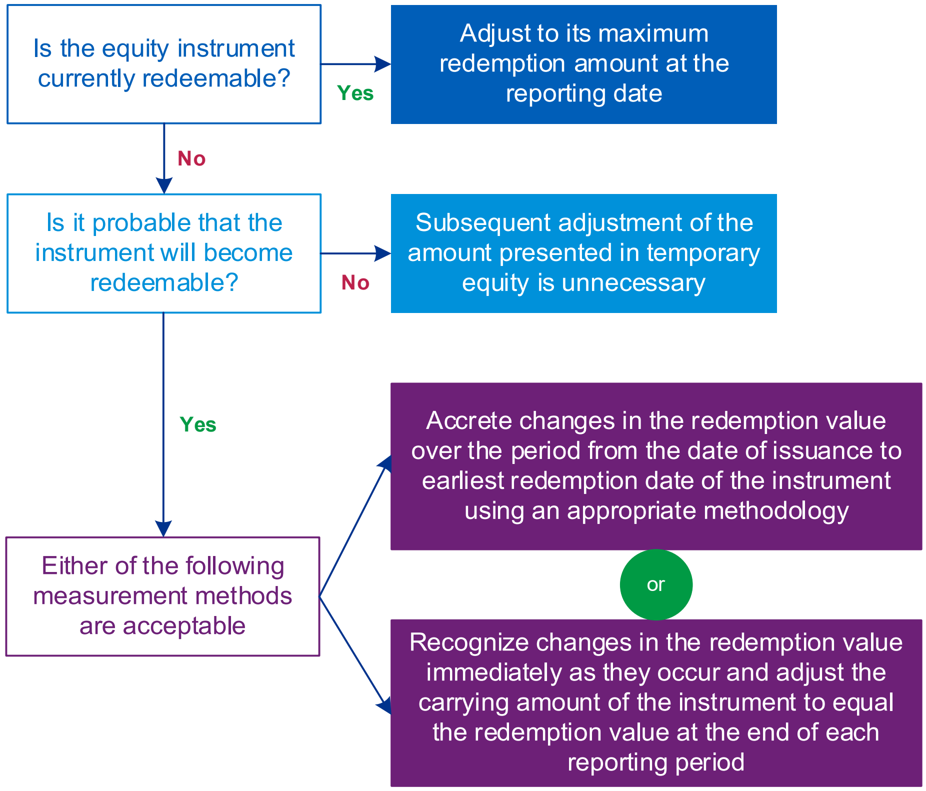
The following table illustrates when NCI might be adjusted further.

	NCI is adjusted further	NCI is not adjusted further
If…	— the redemption amount is greater than the carrying amount after attributing the subsidiary's comprehensive income under Subtopic 810-10; and — the NCI is currently redeemable	— the redemption amount under Section 480-10-S99 is less than what the carrying amount of the NCI would be if it were not redeemable – i.e. the amount after applying the guidance in Subtopic 810-10 only.
Then…	NCI is further adjusted based on its redemption amount under Section 480-10-S99 [480-10-S99-3A]	We believe no downward adjustment is made based on the redemption amount.

Therefore, we believe the subsequent measurement of the redeemable NCI equals the greater of:

— the amount based on the guidance in Subtopic 810-10; and
— the amount measured under Section 480-10-S99.

The following decision tree provides an overview of the measurement of redeemable NCI under Section 480-10-S99. [480-10-S99]



The parent reduces the carrying amount under Section 480-10-S99 if:

— the redemption amount decreases;
— but is still higher than the amount at which the redeemable NCI would be measured under Subtopic 810-10.

In this case, the carrying amount may be reduced only to the extent of previously recognized increases. [480-10-S99-3A.16(c), S99-3A.16(e)]

Question 7.5.110

What is the 'maximum redemption amount' of a currently redeemable NCI?

Interpretive response: If NCI is currently redeemable, its carrying amount is adjusted to the maximum redemption amount at each reporting date under Section 480-10-S99 (see Question 7.5.100).

The maximum redemption amount at each reporting date includes dividends: [480-10-S99-3A.14]

— that are not currently declared or paid but will be payable under the redemption features; and
— for which ultimate payment is not solely within the control of the parent.

If the maximum redemption amount is formula-based (e.g. based on an index or variable), the amount reported in temporary equity is calculated based on the conditions that exist on the reporting date.

If the maximum redemption amount is the fair value of the NCI at the redemption date, the amount reported in temporary equity is the fair value of the equity instrument as of the reporting date.

Question 7.5.120

If NCI is not currently redeemable, how is it measured under Section 480-10-S99?

Interpretive response: If NCI is not currently redeemable and it is not probable that it will be, the parent makes no periodic adjustment to its carrying amount under Section 480-10-S99. The parent also discloses why it is not probable that the NCI will become redeemable. [480-10-S99-3A.15]

If the NCI is not currently redeemable (e.g. because a contingency has not been met), but it is probable that it will be, the parent may apply either of the following accounting methods (as an accounting policy election) to compute the adjustment under Section 480-10-S99. [480-10-S99-3A.15]

- **Method 1.** Adjust the carrying amount of the NCI to its redemption amount over the following period:
  - from the date of issuance, or (if later) the date that it becomes probable that the instrument will become redeemable;
  - to the earliest redemption date of the instrument using an appropriate accretion methodology, usually the effective interest method.

  Any changes in the estimated redemption amount are changes in accounting estimates under Topic 250 (see section 3.4 in KPMG Handbook, Accounting changes and error corrections) that are accounted for prospectively in the accretion computation.
- **Method 2.** Recognize the entire change in the redemption amount each period as it occurs so that the carrying amount of the NCI equals the redemption amount at each reporting date. This method treats the reporting date as if it were also the redemption date for the NCI.

The parent must consistently apply and disclose its chosen accounting method. Further, a parent must disclose the redemption amount if it elects to accrete changes in the redemption amount over the period from the date of issuance to the earliest redemption date. [480-10-S99-3A.24]

Question 7.5.130#

How does the parent recognize the adjustment to redeemable NCI under Section 480-10-S99?

Interpretive response: Net income is not affected by adjustments to reflect the current period change in any excess of a redeemable NCI's Section 480-10-S99 measurement amount over its Subtopic 810-10 measurement amount (see Question 7.5.100). Instead, these adjustments are recognized as adjustments to retained earnings or APIC of the parent and may affect the attribution of the subsidiary's net income to NCI. [480-10-S99-3A.22, 810-10-45-23]

Section 480-10-S99 does not specify the circumstances in which adjustments resulting from its application must be recognized in retained earnings versus APIC. We believe that one acceptable accounting policy is for a parent to recognize the adjustments to NCI from the application of Section 480-10-S99 in retained earnings to the extent that those adjustments increase or decrease the numerator for EPS calculations. Under that approach, any remaining adjustments to NCI from the application of Section 480-10-S99 that do not increase or decrease the numerator of EPS calculations are recognized in APIC.

The discussion below on redeemable preferred and common NCI follows this approach. Other accounting policies for recording adjustments to the carrying amount of NCI from the application of Section 480-10-S99 may also be acceptable.

Redeemable NCI in the form of preferred instruments

For redeemable NCI in the form of preferred instruments, we believe adjustments to the carrying amount under Section 480-10-S99 are reflected as an adjustment to retained earnings. Therefore, they are reflected in the attribution of comprehensive income (loss) to the parent and NCI. This treatment is consistent with how the parent recognizes dividends on subsidiary preferred stock (see Question 7.5.20). [810-10-40-2, 480-10-S99-3A.20, S99-3A(22)]

If the redeemable preferred instruments are the only NCI, the entire adjustment is a charge to the parent's attribution of the subsidiary's net income and a credit to the NCI's attribution of the subsidiary's net income.

However, redeemable preferred instruments are not the only NCI when there is also NCI in the subsidiary in the form of common instruments. In this case, the effect on attribution of the subsidiary's net income to the parent depends on whether the redemption feature was issued, or guaranteed, by the parent.

- **Issued or guarantee by the parent.** The entire adjustment is a charge to the parent's attribution of the subsidiary's net income and a credit to the NCI's attribution of the subsidiary's net income.
- **Not issued or guaranteed by the parent.** The adjustment is attributed to the parent and the common NCI.

See Questions 3.3.20 and 3.3.120 in KPMG Handbook, Earnings per share, for a discussion on computing EPS when there is redeemable NCI in the form of preferred instruments.

Redeemable NCI in the form of common instruments

For redeemable NCI in the form of common instruments, we believe adjustments to the carrying amount under Section 480-10-S99 are reflected as an adjustment to retained earnings or APIC based on the nature of the redemption amount.

If NCI redemption feature is…	Then…
…equal to the fair value of the underlying common instruments	Adjustments to the carrying amount under Section 480-10-S99 are generally recognized as an adjustment to APIC. The adjustments: — do **not** affect the numerator of basic and diluted EPS calculations; and — are **not** included in the attribution of comprehensive income (loss) to the parent and NCI.
…a non-fair value redemption feature	Adjustments to the carrying amount under Section 480-10-S99 may either be recognized as: — adjustments to retained earnings for the entire amount (akin to a dividend) via the attribution of comprehensive income (loss) to the parent and the NCI, with the parent's EPS calculations under the two-class method; or — as adjustments (1) to retained earnings for the amount of the adjustment to the numerator of the parent's EPS calculations under the two-class method for computing EPS and (2) to APIC for the remainder. See Question 5.3.40 in KPMG Handbook, Earnings per share, for a discussion on common shares redeemable at an amount other than fair value.

Question 7.5.140#

How are adjustments to the carrying amount of redeemable NCI under Section 480-10-S99 made if there is an accumulated deficit in retained earnings?

Interpretive response: If there is a deficit in retained earnings, adjustments to the carrying amount of redeemable NCI under Section 480-10-S99 are generally recognized through an adjustment to APIC of the parent. If APIC is then reduced to zero, further adjustments are made to the accumulated deficit through attribution of comprehensive income.

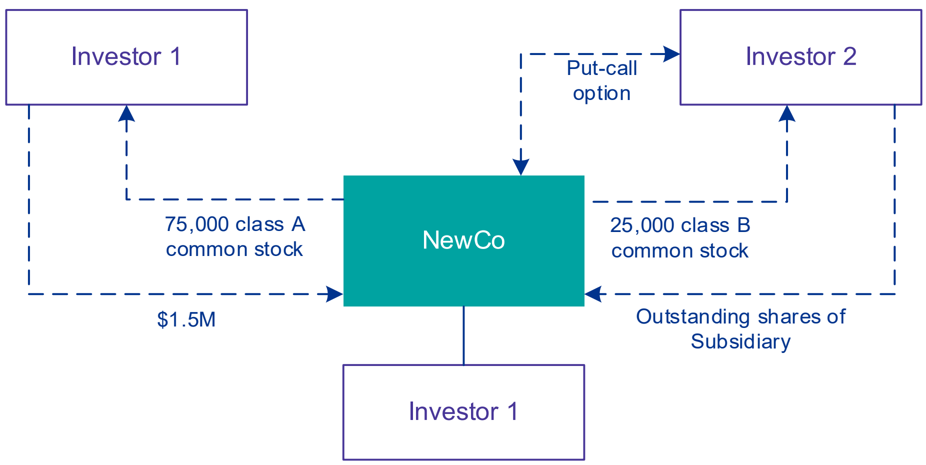
Example 7.5.60
Redeemable NCI – formula-based redemption amount

Background

Investor1 (acquirer) purchases 75% of Subsidiary from Investor2 (seller) for $1.5 million on January 1, Year 1. The transaction is structured as follows:

— Investor2 transfers all of the outstanding shares of Subsidiary to a newly formed entity (NewCo) in exchange for 25,000 Class B common shares; and

— Investor1 transfers $1.5 million to NewCo in exchange for 75,000 Class A common shares.



The Class A and B shares are identical in all respects, except that the terms of the Class B shares provide the following put-call options:

— Put option: Investor2 has the ability to require NewCo to purchase its Class B shares on the seventh anniversary after the acquisition date.
— Call option: NewCo has the right to purchase its Class B shares from Investor2 at any time after the fifth anniversary of the acquisition date.

The embedded put and call options have the same strike price, which is derived by applying a fixed multiple to Subsidiary's trailing EBITDA. The redemption formula is not at fair value or designed to equal or reasonably approximate fair value.

At January 1, Year 1, the fair value of the redeemable NCI is $450,000.

Evaluation

Initial measurement

See Example 7.2.20 for initial measurement.

Subsequent measurement

Investor1's Section 480-10-S99 accounting policies are provided in the following table.

Subsequent measurement (see Question 7.5.120)	Recognize changes in redemption amount immediately as they occur – i.e. adjust carrying amount of the instrument to its current redemption amount at each reporting date.
Recognize adjustments to redeemable instruments (see Question 7.5.130)	— Classify adjustments that affect the numerator of the parent's EPS calculations under the two-class method as increases or decreases to retained earnings. — Classify adjustments that do not affect EPS as increases or decreases to APIC.
Recognize incremental adjustments to carrying amount of redeemable NCI in form of common interests (see Question 7.5.130)	Reflect adjustments directly in EPS calculations to the extent they increase or decrease the numerator of EPS. Do not include these adjustments in the attribution of comprehensive income (loss) to the parent and NCI.

During the interim periods of Year 1, NewCo's net income (loss) and OCI are as shown in the following table.

Table 1

Year 1	Net income (loss)	OCI (loss)	Comprehensive income (loss)
Mar 31	$ 320,000	$ (20,000)	$ 300,000
June 30	$ 160,000	$ 40,000	$ 200,000
Sept 30	$ 360,000	$ (60,000)	$ 300,000
Dec 31	$ (120,000)	$ 20,000	$ (100,000)

At the acquisition date, the fair value of the redeemable NCI was $450,000. At the end of each interim period of Year 1, the fair values of the underlying NCI shares (excluding the redemption feature) are as follows (see Table 4).

- $540,000 at March 31, Year 1
- $580,000 at June 30, Year 1
- $700,000 at September 30, Year 1
- $620,000 at December 31, Year 1.

At the end of each interim period of Year 1, the redemption amounts of the redeemable NCI are as follows (see Table 3):

- $550,000 at March 31, Year 1
- $560,000 at June 30, Year 1
- $690,000 at September 30, Year 1
- $645,000 at December 31, Year 1.

During the interim periods of Year 1, NewCo's net income (loss) and OCI are attributed to the 25% NCI under Subtopic 810-10 as shown in the following table.

Table 2				
Year 1	**Net income (loss) to NCI**	**OCI (loss) to NCI**	**Comprehen-sive income (loss) to NCI**	**NCI Subtopic 810-10 value**
Jan 1 (acquisition)				$450,000
Mar 31	$ 80,000	$ (5,000)	$ 75,000	$525,000
June 30	$ 40,000	$ 10,000	$ 50,000	$575,000
Sept 30	$ 90,000	$(15,000)	$ 75,000	$650,000
Dec 31	$ (30,000)	$ 5,000	$ (25,000)	$625,000

EPS

The NCI is in the form of common interests (Class B common shares) and the redemption formula is based on a fixed multiple of trailing EBITDA, which is not a fair value redemption.

Investor1 does not include Section 480-10-S99 adjustments in the attribution of net income (loss) and OCI to the parent and NCI. As a result, it must apply the two-class method for computing EPS to determine how much of the Section 480-10-S99 adjustment affects the numerator of EPS calculations and is charged to retained earnings.

We believe there are two acceptable approaches in this scenario for determining the numerator adjustment for Investor 1's EPS calculation under the two-class method: the gross changes approach and the kicker approach.

Gross changes approach	Investor1 adjusts the numerator of its EPS calculations to reflect the increase (decrease) in any excess of the Section 480-10-S99 value amount over the Subtopic 810-10 value.
Kicker approach	Investor1 adjusts the numerator of its EPS calculations to reflect the increase (decrease) in any excess of the Section 480-10-S99 value over the greater of: — the Subtopic 810-10 value; and — the fair value of the NCI.

Gross changes approach

The following table shows for the redeemable NCI for each interim period of Year 1:

- the Subtopic 810-10 value;
- any excess of the Section 480-10-S99 value over the Subtopic 810-10 value; and
- the change in the excess from the prior period.

This information is necessary to determine the EPS numerator adjustment under the gross changes approach.

Table 3					
Year 1	Subtopic 810-10 value (A)	Section 480-10-S99 value (B)	Carrying amount (greater of A and B)	B - A	Increase (decrease) in B - A
Jan 1 (acquisition)	$450,000				
Mar 31	$525,000	$550,000	$550,000	$25,000	$ 25,000
June 30	$575,000	$560,000	$575,000	N/A	$ (25,000)
Sept 30	$650,000	$690,000	$690,000	$40,000	$ 40,000
Dec 31	$625,000	$645,000	$645,000	$20,000	$ (20,000)

Kicker approach

The following table compares the Subtopic 810-10 value, the fair value and the Section 480-10-S99 value of the redeemable NCI to determine the EPS numerator adjustment under the kicker approach.

Table 4						
Year 1	Subtopic 810-10 value (A)	Fair value (B)	Greater of A and B (C)	Section 480-10-S99 value (D)	D in excess of C	Increase (decrease) in any excess of D over C
Jan 1 (acquisition)	$450,000					
Mar 31	$525,000	$540,000	$540,000	$550,000	$10,000	$ 10,000
June 30	$575,000	$580,000	$580,000	$560,000	N/A	$ (10,000)
Sept 30	$650,000	$700,000	$700,000	$690,000	N/A	–
Dec 31	$625,000	$620,000	$625,000[1]	$645,000	$20,000	$ 20,000

Note:

1. The Subtopic 810-10 value of the NCI exceeds its fair value by $5,000 at December 31, Year 1, which may indicate that certain assets of NewCo are impaired. This example assumes that no impairment charge was required to be recognized under applicable US GAAP.

Comparing the gross changes and kicker approaches

The following table summarizes the adjustments to the numerator of EPS under the two-class method for each period using the gross changes approach and the kicker approach. Calculations of these amounts are presented in the previous two tables.

Table 5		
Year 1	Charges (credits) to numerator of EPS calculations	
	Gross changes approach (Table 3)	Kicker approach (Table 4)
Mar 31	$ 25,000	$ 10,000
June 30	$(25,000)	$(10,000)
Sept 30	$ 40,000	–
Dec 31	$(20,000)	$ 20,000

March 31, Year 1

- NewCo's comprehensive income is $300,000 (Table 1), which is allocated $225,000 (75%) to Investor1 (parent) and $75,000 (25%) to the NCI (Table 2).
- The resulting measurement of the NCI under Subtopic 810-10 is $525,000 (Table 2).
- Under the guidance in Section 480-10-S99, the NCI is measured at $550,000. This amount is $25,000 more than the Subtopic 810-10 value at the reporting date (Table 3).
- Investor1 measures the NCI at $550,000, which is the greater of the Subtopic 810-10 value and the Section 480-10-S99 value (Table 3).
- If Investor1 uses the kicker approach in applying the two-class method (Tables 4 and 5), it records the following journal entry at March 31, Year 1. This entry is made after allocating comprehensive income for the period between parent and NCI.

	Debit	*Credit*
Retained earnings	10,000	
APIC	15,000	
NCI		25,000
To increase carrying amount of NCI to measurement amount under Section 480-10-S99.		

If Investor1 used the gross changes approach (Tables 3 and 5), it would recognize the entire $25,000 adjustment in retained earnings.

The entire $550,000 redeemable NCI balance as of March 31, Year 1 is presented in temporary equity.

June 30, Year 1

- NewCo's comprehensive income is $200,000 (Table 1), which is allocated $150,000 (75%) to Investor1 (parent) and $50,000 (25%) to the NCI (Table 2).
- The resulting measurement of the NCI under Subtopic 810-10 is $575,000 (Table 2).
- Under the guidance in Section 480-10-S99, the NCI is measured at $560,000 (Table 3). This amount is $15,000 less than the Subtopic 810-10 value at the reporting date.
- Investor1 measures the NCI at $575,000, which is the greater of the Subtopic 810-10 value and the Section 480-10-S99 value (Table 3).
- At the end of the preceding period (March 31, Year 1), the Section 480-10-S99 value exceeded the Subtopic 810-10 value by $25,000 and resulted in measuring the NCI at $550,000 (Table 3).
- If Investor1 uses the kicker approach in applying the two-class method (Tables 4 and 5), it records the following journal entry at June 30, Year 1.

This entry is made after allocating comprehensive income for the period between parent and NCI.

	Debit	Credit
NCI	25,000	
Retained earnings		10,000
APIC		15,000
To reduce carrying amount of NCI to its measurement amount under Subtopic 810-10.		

If Investor1 used the gross changes approach (Tables 3 and 5), it would recognize the entire $25,000 adjustment in retained earnings.

The entire $575,000 redeemable NCI balance as of June 30, Year 1 is presented in temporary equity.

September 30, Year 1

- NewCo's comprehensive income is $300,000 (Table 1), which is allocated $225,000 (75%) to Investor1 (parent) and $75,000 (25%) to the NCI (Table 2).
- The resulting measurement of the NCI under Subtopic 810-10 is $650,000 (Table 2).
- Under the guidance in Section 480-10-S99, the NCI is measured at $690,000. This amount is $40,000 more than the Subtopic 810-10 value at the reporting date (Table 3).
- Investor1 measures the NCI at $690,000, which is the greater of the Subtopic 810-10 value and the Section 480-10-S99 value (Table 3).
- At the end of the preceding period (June 30, Year 1), the Subtopic 810-10 value exceeded the Section 480-10-S99 value by $15,000 and resulted in measuring the NCI at $575,000 (Table 3).
- If Investor1 uses the kicker approach in applying the two-class method (Tables 4 and 5), it records the following journal entry at September 30, Year 1. This entry is made after allocating comprehensive income for the period between parent and NCI.

	Debit	Credit
APIC	40,000	
NCI		40,000
To increase carrying amount of NCI to measurement amount under Section 480-10-S99.		

If Investor1 used the gross changes approach (Tables 3 and 5), it would recognize the entire $40,000 adjustment in retained earnings.

The entire $690,000 redeemable NCI balance as of September 30, Year 1 is presented in temporary equity.

December 31, Year 1

- NewCo's comprehensive loss is $100,000 (Table 1), which is allocated $75,000 (75%) to Investor1 (parent) and $25,000 (25%) to the NCI (Table 2).
- The resulting measurement of the NCI under Subtopic 810-10 is $625,000 (Table 2).
- Under the guidance in Section 480-10-S99, the NCI is measured at $645,000. This amount is $20,000 more than the Subtopic 810-10 value at the reporting date (Table 3).
- Investor1 measures the NCI at $645,000, which is the greater of the Subtopic 810-10 value and the Section 480-10-S99 value (Table 3).
- At the end of the preceding period (September 30, Year 1), the Section 480-10-S99 value exceeded the Subtopic 810-10 value by $40,000 and resulted in measuring the NCI at $690,000 (Table 3).
- If Investor1 uses the kicker approach in applying the two-class method (Tables 4 and 5), it records the following entry at December 31, Year 1. This entry is made after allocating comprehensive income for the period between parent and NCI.

	Debit	*Credit*
NCI	20,000	
Retained earnings	20,000	
APIC		40,000
To reduce carrying amount of NCI to measurement amount under Section 480-10-S99.		

If Investor1 used the gross changes approach (Tables 3 and 5), it would recognize the entire $20,000 adjustment in retained earnings.

The entire $645,000 redeemable NCI balance as of December 31, Year 1 is presented in temporary equity.

Example 7.5.70
Redeemable NCI – fair-value redemption amount

Background

Assume the same facts as Example 7.5.60, except that the strike price of both the put and call option is the fair value of the underlying shares at the redemption date.

Evaluation

Initial measurement

See Example 7.2.20, scenario 2, for initial measurement.

Subsequent measurement

Investor1's Section 480-10-S99 accounting policies are provided in the following table.

Subsequent measurement (see Question 7.5.120)	Recognize changes in redemption amount immediately as they occur – i.e. adjust the carrying amount of the instrument to its current redemption amount at each reporting date.
Recognize adjustments to redeemable instruments (see Question 7.5.130)	— Classify adjustments that affect the numerator of the parent's EPS calculations under the two-class method as increases or decreases to retained earnings. — Classify adjustments that do not affect EPS as increases or decreases to APIC.

During the interim periods of Year 1, NewCo's net income (loss) and OCI (loss) are as shown in the following table.

Table 1

Year 1	Net income (loss)	OCI (loss)	Comprehensive income (loss)
Mar 31	$ 320,000	$(20,000)	$ 300,000
June 30	$ 160,000	$ 40,000	$ 200,000
Sept 30	$ 360,000	$(60,000)	$ 300,000
Dec 31	$(120,000)	$ 20,000	$(100,000)

At the acquisition date, the fair value of the redeemable NCI was $450,000. At the end of each interim period of Year 1, the fair values of the underlying NCI shares (excluding the redemption feature) were as follows (see Table 3):

- $540,000 at March 31, Year 1
- $580,000 at June 30, Year 1
- $700,000 at September 30, Year 1
- $620,000 at December 31, Year 1.

During the interim periods of Year 1, NewCo's net income (loss) and OCI is attributed to the 25% NCI under Subtopic 810-10, as shown in the following table.

Table 2

Year 1	Net income (loss) to NCI	OCI (loss) to NCI	Comprehensive income (loss) to NCI	NCI Subtopic 810-10 value
Jan 1 (acquisition)				$450,000
Mar 31	$ 80,000	$ (5,000)	$ 75,000	$525,000
June 30	$ 40,000	$ 10,000	$ 50,000	$575,000
Sept 30	$ 90,000	$(15,000)	$ 75,000	$650,000
Dec 31	$(30,000)	$ 5,000	$(25,000)	$625,000

For each interim period of Year 1, the following table shows the carrying amounts of the redeemable NCI, any excess of the Section 480-10-S99 value over the Subtopic 810-10 value, and the change in that excess from the prior period.

Table 3

Year 1	Subtopic 810-10 value (A)	Section 480-10-S99 value (B)	Carrying amount (greater of A and B)	B - A	Increase (decrease) in B - A
Jan 1 (acquisition)	$450,000				
Mar 31	$525,000	$540,000	$ 540,000	$15,000	$ 15,000
June 30	$575,000	$580,000	$ 580,000	$ 5,000	$(10,000)
Sept 30	$650,000	$700,000	$ 700,000	$50,000	$ 45,000
Dec 31	$625,000	$620,000	$625,000[1]	N/A	$(50,000)

Note:

1. The Subtopic 810-10 balance of the NCI exceeds its fair value by $5,000 at December 31, Year 1, which may indicate that certain assets of the subsidiary are impaired. This example assumes that no impairment charge was required to be recognized under applicable US GAAP.

EPS

The NCI is in the form of common interests (Class B common shares) and is redeemable for an amount equal to the fair value of the underlying NCI shares at the redemption date. If the redemption amount is at fair value, adjustments to the carrying amount of the redeemable controlling interests to reflect the measurement guidance in Section 480-10-S99 do not affect EPS. Therefore, Investor1 does not include Section 480-10-S99 adjustments in:

- the attribution of comprehensive income to the parent and NCI; or
- the numerator of EPS.

March 31, Year 1

- NewCo's comprehensive income is $300,000 (Table 1), which was allocated $225,000 (75%) to the Investor1 (parent) and $75,000 (25%) to the NCI (Table 2).
- The resulting measurement of the NCI under Subtopic 810-10 is $525,000 (Table 2).
- Under the guidance in Section 480-10-S99, the NCI is measured at $540,000. This amount is $15,000 more than the Subtopic 810-10 value at the reporting date (Table 3).
- Investor1 measures the NCI at $540,000 (which is the greater of the Subtopic 810-10 value and Section 480-10-S99 value (Table 3)) and records the following journal entry at March 31, Year 1. This entry is made after allocating comprehensive income for the period between parent and NCI.

	Debit	Credit
APIC	15,000	
NCI		15,000
To increase carrying amount of NCI to its measurement amount under Section 480-10-S99.		

The entire $540,000 redeemable NCI balance as of March 31, Year 1 is presented in temporary equity.

June 30, Year 1

— NewCo's comprehensive income is $200,000 (Table 1), which is allocated $150,000 (75%) to the parent and $50,000 (25%) to the NCI (Table 2).

— The resulting measurement of the NCI under Subtopic 810-10 is $575,000 (Table 2).

— Under the guidance in Section 480-10-S99, the NCI is measured at $580,000. This amount is $5,000 more than the Subtopic 810-10 value at the reporting date.

— Investor1 measures the NCI at $580,000, which is the greater of the Subtopic 810-10 value and the Section 480-10-S99 value (Table 3).

— At the end of the preceding period (March 31, Year 1), the Section 480-10-S99 value exceeded the Subtopic 810-10 value by $15,000 and resulted in measuring the NCI at $540,000 (Table 3).

— Investor1 records the following journal entry at June 30, Year 1. This entry is made after allocating comprehensive income for the period between parent and NCI.

	Debit	Credit
NCI	10,000	
APIC		10,000
To reduce carrying amount of NCI to its measurement amount under Section 480-10-S99.		

The entire $580,000 redeemable NCI balance as of June 30, Year 1 is presented in temporary equity.

September 30, Year 1

— NewCo's comprehensive income is $300,000 (Table 1), which is allocated $225,000 (75%) to Investor1 (parent) and $75,000 (25%) to the NCI (Table 2).

— The resulting measurement of the NCI under Subtopic 810-10 is $650,000 as of September 30, Year 1 (Table 2).

— Under the guidance in Section 480-10-S99, the NCI is measured at $700,000. This amount is $50,000 more than the Subtopic 810-10 value at the reporting date (Table 3).

- Investor1 measures the NCI at $700,000, which is the greater of the Subtopic 810-10 value and the Section 480-10-S99 value (Table 3).
- At the end of the preceding period (June 30, Year 1), the Section 480-10-S99 value exceeded the Subtopic 810-10 value by $5,000 and resulted in measuring the NCI at $580,000 (Table 3).
- Investor1 records the following journal entry at September 30, Year 1. This entry is made after allocating comprehensive income for the period between the controlling interest and NCI.

	Debit	*Credit*
APIC	45,000	
NCI		45,000
To increase carrying amount of NCI to its measurement amount under Section 480-10-S99.		

The entire $700,000 redeemable NCI balance as of September 30, Year 1 is presented in temporary equity.

December 31, Year 1

- NewCo's comprehensive loss is $100,000 (Table 1), which is allocated $75,000 (75%) to Investor1 (parent) and $25,000 (25%) to the NCI (Table 2).
- The resulting measurement of the NCI under Subtopic 810-10 is $625,000.
- Under the guidance in Section 480-10-S99, the NCI is measured at $620,000. This amount is $5,000 less than the Subtopic 810-10 value at the reporting date (Table 3).
- Investor1 measures the NCI at $625,000, which is the greater of the Subtopic 810-10 value and the Section 480-10-S99 value (Table 3).
- At the end of the preceding period (September 30, Year 1), the Section 480-10-S99 value exceeded the Subtopic 810-10 value by $50,000 and resulted in measuring NCI at $700,000 (Table 3).
- Investor1 records the following journal entry at December 31, Year 1. This entry is made after allocating comprehensive income for the period between the parent and NCI.

	Debit	*Credit*
NCI	50,000	
APIC		50,000
To reduce carrying amount of NCI to its measurement amount under Section 480-10-S99.		

The entire $625,000 redeemable NCI balance as of December 31, Year 1 is presented in temporary equity.

Example 7.5.80
Redeemable NCI – fixed redemption amount plus accumulated unpaid dividends

Background

On January 1, Year 1, Enterprise purchases 1,000 shares of Legal Entity's preferred stock for $603,000 ($603 per share), representing 50% of Legal Entity's total preferred shares outstanding.

The preferred shares have the following attributes:

- an aggregate stated value of $1 million ($1,000 per share);
- cumulative dividends payable at a rate of 8%, payable semi-annually;
- an embedded put option that provides the holder with the ability to sell the shares back to Legal Entity at any time after December 31, Year 9 (nine years from the date of issuance) for an amount equal to the stated value of the shares plus accumulated, unpaid dividends; and
- no mandatory redemption date.

Legal Entity accounts for the redeemable preferred shares as equity instruments and presents them in temporary equity. Enterprise accounts for the preferred shares as available-for-sale debt securities under Subtopic 326-30.

Evaluation

Years 1 – 4 and initial measurement at the business combination date

See Example 7.2.30.

Subsequent measurement – Year 5 (after the business combination)

Enterprise's Section 480-10-S99 accounting policies are provided in the following table.

Subsequent measurement (see Question 7.5.120)	Accrete changes in redemption value from the date of issuance to the earliest redemption date using the effective interest method.
Recognize adjustments to redeemable instruments (see Question 7.5.130)	— Classify adjustments that affect the numerator of the parent's EPS calculations under the two-class method as increases or decreases to retained earnings. — Classify adjustments that do not affect EPS as increases or decreases to APIC.
Recognize incremental adjustments to carrying amount of redeemable NCI in form of preferred instruments (see Question 7.5.130)	Reflect adjustments in the attribution of comprehensive income to the parent and NCI.

Consistent with Enterprise's accounting policy, the $797,000 initial fair value of the redeemable NCI on January 1, Year 5 is accreted to its redemption value on December 31, Year 9 using the effective interest method.

Legal Entity's cumulative preferred stock dividends are expected to be paid on redemption. As a result, the $797,000 initial fair value is accreted to the $1,720,000 redemption amount at December 31, Year 9, calculated as follows:

- $1.0 million stated value; plus
- $720,000 of accumulated dividends (January 1, Year 1 original issuance date through the December 31, Year 9 redemption date).

EPS

The NCI is in the form of preferred shares. As a result, changes to its carrying amount under Section 480-10-S99 are reflected in the consolidated financial statements in the attribution of Legal Entity's net income (loss) between the parent and NCI – i.e. they naturally increase or decrease income available to common shareholders. Therefore, no additional adjustments are made to the numerator in EPS calculations (see Question 7.5.130).

Entries

Enterprise records the following journal entry in Year 5 to reflect accretion of the redeemable NCI under Section 480-10-S99. (In subsequent years, application of the effective interest method will cause the amount of annual accretion to increase.)

	Debit	*Credit*
Retained earnings	132,000	
NCI		132,000
To increase carrying amount of NCI to its measurement amount under Section 480-10-S99.		

The entire $929,000 redeemable NCI balance as of December 31, Year 5 is presented in temporary equity.

The $132,000 of Year 5 accretion (and the $929,000 accreted value at the end of Year 5) were determined based on an implied effective yield of 16% at the January 1, Year 5 acquisition date. The calculations of the accreted value and Year 5 accretion in this example also assume that:

- the shares will be put back to Legal Entity on December 31, Year 9, at the earliest redemption date; and
- the cumulative preferred stock dividends will be paid upon redemption – i.e. they will not be declared and paid before the redemption date.

Different assumptions might be appropriate in other scenarios depending on the specific facts and circumstances.

7.5.30 Changes in ownership – parent retains control

Excerpt from ASC 810-10

General

> Changes in a Parent's Ownership Interest in a Subsidiary

45-21A The guidance in paragraphs 810-10-45-22 through 45-24 applies to the following:

a. Transactions that result in an increase in ownership of a subsidiary
b. Transactions that result in a decrease in ownership of either of the following while the parent retains a controlling financial interest in the subsidiary:
   1. A subsidiary that is a business or a **nonprofit activity**, except for either of the following:
      i. Subparagraph superseded by Accounting Standards Update No. 2017-05
      ii. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360).
      iii. A transfer of a good or service in a contract with a customer within the scope of Topic 606.
   2. A subsidiary that is not a business or a nonprofit activity if the substance of the transaction is not addressed directly by guidance in other Topics that include, but are not limited to, all of the following:
      i. Topic 606 on revenue from contracts with customers
      ii. Topic 845 on exchanges of nonmonetary assets
      iii. Topic 860 on transferring and servicing financial assets
      iv. Topic 932 on conveyances of mineral rights and related transactions
      v. Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

45-22 A parent's ownership interest in a subsidiary might change while the parent retains its controlling financial interest in the subsidiary. For example, a parent's ownership interest in a subsidiary might change if any of the following occur:

a. The parent purchases additional ownership interests in its subsidiary.
b. The parent sells some of its ownership interests in its subsidiary.
c. The subsidiary reacquires some of its ownership interests.
d. The subsidiary issues additional ownership interests.

45-23 Changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary shall be accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners). Therefore, no gain or loss shall be recognized in consolidated net income or comprehensive income. The carrying amount of the noncontrolling interest shall be adjusted to reflect the change in its ownership interest in the subsidiary. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent. Example 1 (paragraph 810-10-55-4B) illustrates the application of this guidance.

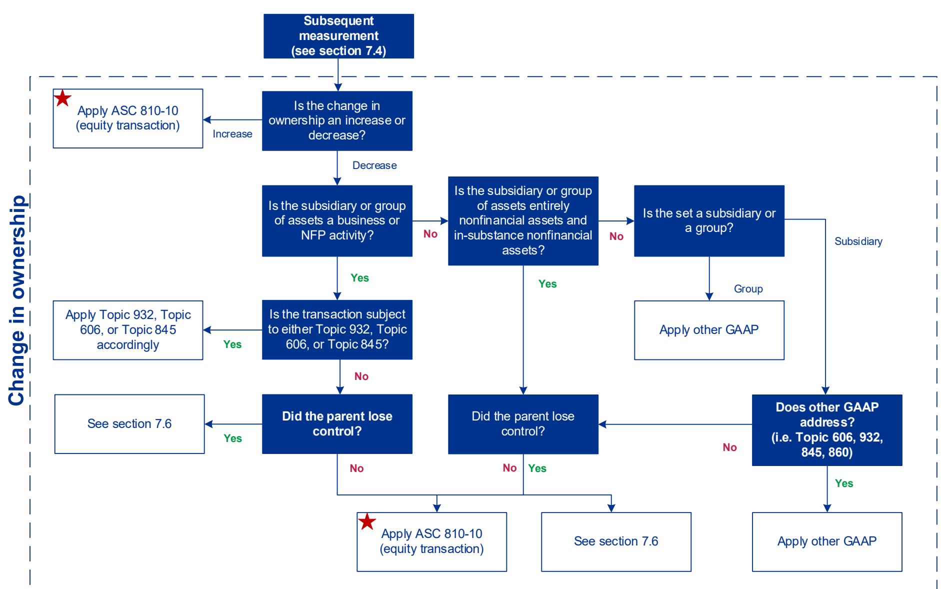
45-24 A change in a parent's ownership interest might occur in a subsidiary that has accumulated other comprehensive income. If that is the case, the carrying amount of accumulated other comprehensive income shall be adjusted to reflect the change in the ownership interest in the subsidiary through a corresponding charge or credit to equity attributable to the parent. Example 1, Case C (paragraph 810-10-55-4F) illustrates the application of this guidance.

> Redemption of a Subsidiary's Redeemable Stock

>> Mandatorily Redeemable Preferred Stock Not Accounted for as a Liability

40-2 Section 480-10-25 does not require mandatorily redeemable preferred stock to be accounted for as a liability under certain conditions. If such conditions apply and the mandatorily redeemable preferred stock is not accounted for as a liability, then the entity's acquisition of a subsidiary's mandatorily redeemable preferred stock shall be accounted for as a capital stock transaction. Accordingly, the consolidated entity would not recognize in its income statement any gain or loss from the acquisition of the subsidiary's preferred stock. In the **consolidated financial statements**, the dividends on a subsidiary's preferred stock, whether mandatorily redeemable or not, would be included in noncontrolling interest as a charge against income.

Changes in ownership in which the parent retains control can occur for a variety of reasons. The following decision tree is an overview of how a parent accounts for ownership changes.



Subtopic 810-10 requires that changes in a parent's ownership interest in which the parent retains control be accounted for as equity transactions – i.e. no gain or loss is recognized. [810-10-45-23]

Question 7.5.150

How does a parent account for an increase in ownership in a subsidiary?

Interpretive response: A parent's ownership interest increases when (not exhaustive): [810-10-45-22]

— the parent acquires shares from the NCI holder(s);
— the subsidiary issues new shares and the parent purchases proportionately more than the NCI holder(s); or
— the subsidiary reacquires shares and the parent sells proportionately less than the NCI holder(s).

There is no difference between transactions in which the parent acquires a portion of the NCI by making a new cash investment in the subsidiary and transactions in which the parent directly acquires a portion of the shares from the NCI holder(s) for cash. Once the parent obtains a controlling financial interest, all increases in a parent's ownership interest in a subsidiary are accounted for as equity transactions. This guidance equally applies regardless of whether the subsidiary is a VOE or VIE. [810-10-45-23]

Parent's ownership interest increases	The carrying amount of the NCI is decreased to reflect the increase in the parent's ownership in the book value of the subsidiary. Any difference between the following is recognized in APIC: — the fair value of the consideration paid; and — the amount by which the NCI is decreased. No gain or loss is recognized in comprehensive income.
Redeemable NCI is acquired by the parent	Any difference between the following is recognized in APIC: — the purchase price; and — the carrying amount of the redeemable NCI on the date of acquisition (see section 7.5.20). No gain or loss is recognized in comprehensive income.

The amount by which the NCI is decreased reflects the change in the ownership interest in the subsidiary. The post-transaction NCI is generally measured based on the NCI holder's post-transaction interest in the subsidiary's post-transaction book value.

If the subsidiary has AOCI, that AOCI is also adjusted to reflect the change in ownership of the subsidiary through an adjustment to equity attributable to the parent. [810-10-45-24]

The same accounting applies when a parent increases its ownership interest through a common control transaction between two or more subsidiaries. Any difference arising between the consideration paid and the NCI adjustment is recognized in equity. See Example 28.2a in KPMG Handbook, Business combinations.

See Example 7.5.140 for an illustration of an increase in ownership involving redeemable NCI, and Question 7.5.155 for an increase in ownership involving contingent consideration.

Question 7.5.155

How does a parent account for contingent consideration in a transaction that increases its ownership in a subsidiary?

Background: A transaction that increases a parent's ownership interest in a subsidiary may include contingent consideration payable to the selling NCI holder. For example, the parent acquires NCI and agrees to transfer cash, equity interests or other assets to the seller upon the occurrence or nonoccurrence of a future event.

Topic 805 addresses the acquirer's accounting for contingent consideration transferred to a seller (i.e. former parent of the subsidiary) in a business combination. However, it does not address the acquirer's accounting for contingent consideration transferred to acquire NCI. Further, while Topic 810 provides general guidance for the acquisition of NCI (see Question 7.5.150), it does not provide explicit guidance on contingent consideration.

Interpretive response: We believe a parent should first evaluate whether other GAAP applies to the contingent consideration.

— If the contingent consideration is compensatory, the parent should account for the payments under the applicable compensation guidance (e.g. Topic 710 on deferred compensation or 718 on share-based payments).

— If not compensatory, the parent should consider the applicability of the financial instruments guidance in Topic 480 on distinguishing liabilities from equity and/or Topic 815 on derivatives and hedging. If that guidance is applicable, the parent initially measures the contingent consideration at fair value and records that amount in equity according to the guidance in Question 7.5.150. If liability classified, the subsequent changes in fair value are recognized in earnings.

If the contingent consideration is not in the scope of other GAAP, in our experience, there is diversity in practice and the following are examples of acceptable approaches.

— **Topic 805 approach.** The parent initially recognizes and measures the contingent consideration liability at fair value, with that amount recognized in equity according to the guidance in Question 7.5.150. Subsequent changes in fair value are recognized in earnings.

— **Asset acquisition approach.** The parent recognizes a liability for the contingent payment when probable and estimable under Topic 450. Any adjustments are recognized directly in equity according to the guidance in Question 7.5.150.

A parent should apply its approach consistently.

Question 7.5.160

How does a parent account for a decrease in ownership in a subsidiary while retaining a controlling financial interest?

Interpretive response: A parent's ownership interest decreases when (not exhaustive): [810-10-45-22]

— the parent sells shares to the NCI holder(s);
— the subsidiary issues new shares and the parent purchases proportionately less than the NCI holder(s); or
— the subsidiary reacquires shares and the parent sells proportionately more than the NCI holder(s).

Decreases in a parent's ownership interest in a subsidiary while the parent retains its controlling financial interest are accounted for as equity transactions. This guidance applies regardless of whether the subsidiary is a VOE, a VIE, a business or not a business. [810-10-45-23]

Parent's ownership interest decreases	The carrying amount of the NCI is **increased** to reflect the **decrease** in the parent's ownership in the book value of the subsidiary. Any difference between the following is recognized in APIC: — the fair value of the consideration **received**; and — the amount by which the NCI is **increased**. No gain or loss is recognized in comprehensive income.

The post-transaction NCI is generally measured based on the NCI holder's post-transaction interest in the subsidiary's post-transaction book value (the Subtopic 810-10 value). This measurement applies even if redeemable NCI is issued in the transaction, which is usually measured at fair value under Section 480-10-S99 (see Question 7.2.140). The difference between the Subtopic 810-10 measurement value and the redeemable NCI's fair value is recognized in APIC. We believe this difference does not affect the parent's EPS calculations. Question 7.5.165 discusses when to apply this guidance to preferred shares.

If the subsidiary has AOCI, that AOCI is also adjusted to reflect the change in ownership of the subsidiary through an adjustment to equity attributable to the parent. [810-10-45-24]

See Example 7.5.130 for an illustration of a decrease in ownership involving redeemable NCI.

Question 7.5.165

How does a parent account for a subsidiary's issuance of preferred shares to NCI holders while retaining a controlling financial interest?

Background: Common and preferred shares in a subsidiary that are not held by the parent are NCI in the consolidated financial statements. Unlike common stock, preferred stock is generally entitled to a liquidation preference consisting of the par amount and/or cumulative unpaid dividends – i.e. it ordinarily does not have the characteristics of a residual equity interest in the subsidiary.

In other cases, preferred shares are more like traditional common stock and may represent a residual interest – e.g. they are perpetual in nature, have no stated dividend and are not entitled to a liquidation preference.

Interpretive response: It depends on whether the preferred shares represent a residual interest in the entity.

Not a residual interest

An exception to the guidance in Question 7.5.160 arises when a subsidiary issues preferred shares to an NCI holder that do not represent a residual interest. In such case, we believe the preferred shares should be classified as NCI, but should be measured at fair value (i.e. the amount of the cash proceeds received). That is, there should be no adjustment to the parent's equity accounts as described in Question 7.5.160; this is because the parent's residual interest in the subsidiary does not change.

Residual interest

When preferred shares represent a residual interest in the entity, we believe the general guidance in Question 7.5.160 applies.

Example 7.5.90
Sale by parent of a portion of its ownership interest in a subsidiary

Background

The following information about Subsidiary is relevant.

Common stock of Subsidiary	
Common stock outstanding	10,000 shares
Owned by Parent	10,000 shares
Carrying amount of equity in consolidated financial statements	$200,000

Parent sells 2,000 shares in Subsidiary to an unrelated entity for $50,000 in cash. This transaction reduces Parent's ownership interest in Subsidiary from 100% to 80%.

Evaluation

This transaction is accounted for by recognizing NCI in the amount of $40,000 ($200,000 × 20%). Parent recognizes the $10,000 excess of the cash received ($50,000) over the adjustment to the carrying amount of NCI ($40,000) as an increase in APIC attributable to Parent. The journal entry is as follows.

	Debit	Credit
Cash	50,000	
NCI		40,000
APIC[1]		10,000
To record sale of shares in Subsidiary.		

Note:
1. If Parent is an NFP, it recognizes the $10,000 increase as an increase in net assets (generally unrestricted net assets).

Example 7.5.100
Issuance of additional shares by a subsidiary

Background

The following information about Subsidiary is relevant.

Common stock of Subsidiary	
Common stock outstanding	10,000 shares
Owned by Parent	9,000 shares
Owned by NCI	1,000 shares
Carrying amount of equity in consolidated financial statements	$300,000
Attributable to Parent	$270,000
Attributable to NCI	$30,000

Subsidiary issues 2,000 previously unissued shares to a third party for $120,000 in cash. This reduces Parent's ownership interest in Subsidiary from 90% to 75% (9,000 shares owned by Parent ÷ 12,000 issued shares).

Evaluation

Although Parent's ownership percentage in Subsidiary is reduced when Subsidiary issues shares to the third party, Parent's investment in Subsidiary increases to $315,000, as calculated in the following table.

Carrying amount of equity (initial)	$300,000
Cash paid by third party in exchange for shares	120,000
Carrying amount of equity (post-sale)	$420,000
Parent's ownership (post-sale)	× 75%
Carrying amount of equity attributable to Parent (post-sale)	$315,000

Parent recognizes a $45,000 increase in its investment in Subsidiary ($315,000 – $270,000) and a corresponding increase in APIC. Further, NCI is increased to

$105,000, calculated as 25% of $420,000. The journal entry (after eliminating entries) is as follows:

	Debit	*Credit*
Cash	120,000	
NCI		75,000
APIC[1]		45,000
To record issuance of Subsidiary shares.		

Note:
1. If Parent is an NFP, it recognizes the $45,000 increase as an increase in net assets (generally unrestricted net assets).

Example 7.5.110
Acquisition of NCI by parent of a subsidiary that has AOCI

Background

The following information about Subsidiary is relevant.

Common stock of Subsidiary	
Common stock outstanding	10,000 shares
Owned by Parent	8,000 shares
Owned by NCI	2,000 shares
Carrying amount of equity attributable to NCI	$48,000
AOCI attributable to NCI (included in equity)	$4,000

Parent pays $30,000 in cash to purchase 1,000 shares held by the NCI (50% of the NCI). This increases Parent's ownership interest in Subsidiary from 80% to 90%.

Evaluation

Parent's ownership percentage in Subsidiary and its share of consolidated AOCI increases when it purchases shares from the NCI, as calculated in following table.

Carrying amount of equity attributable to NCI (initial)	$48,000
Percentage of NCI equity purchased by Parent	× 50%
Carrying amount of NCI equity purchased by Parent[1]	$24,000
Cash paid by Parent	$30,000
Excess of cash paid over carrying amount of NCI equity[2]	$6,000

AOCI attributable to NCI (included in equity)	$4,000
Percentage of NCI equity purchased by Parent	× 50%
Increase to Parent's share of AOCI[3]	$2,000

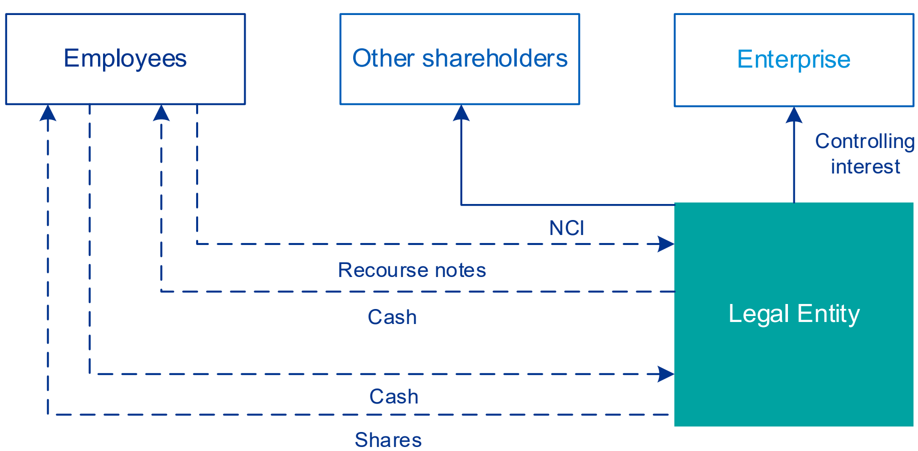
Notes:
1. The transaction is recognized by reducing the carrying amount of the NCI by $24,000.
2. The $6,000 excess of the cash paid over the adjustment to the carrying amount of NCI is recognized as a decrease in APIC attributable to Parent.
3. Parent's share of AOCI is increased by $2,000 through a corresponding decrease in APIC attributable to Parent.

The journal entry (after eliminating entries) is as follows.

	Debit	*Credit*
NCI	24,000	
APIC	8,000	
Cash		30,000
AOCI		2,000
To record Parent's acquisition of Subsidiary shares.		

Example 7.5.120
Shareholder loans and NCI

Background



Legal Entity enters into recourse promissory notes with its employees, who use the proceeds to purchase shares of Legal Entity.

Note: This transaction is in the scope of Topic 505 and is outside the scope of Topic 718 (compensation) because the notes have recourse. If the promissory notes are nonrecourse, the issuance of equity to employees concurrently is accounted for similar to an employee share option under paragraph 718-10-25-4. See Q&As 1.13 and 1.16 in KPMG Handbook, Share-based payments, for additional discussion about the accounting for options on subsidiary shares.

Evaluation

The issuance of Legal Entity's shares results in dilution of Enterprise's interest in Legal Entity – i.e. NCI is increased for the issuance of new shares to employees.

Enterprise also recognizes an offsetting decrease to NCI for the extension of the promissory notes. This is because under Topic 505 (equity), the promissory notes are recognized with an adjustment to Legal Entity's equity. [505-10-45-2]

Enterprise calculates the adjustment to APIC as the difference between: [810-10-45-23]

- the fair value of the consideration received; and
- the adjustment to the carrying amount of NCI, excluding the effect of the reduction in NCI associated with the related loan.

Enterprise attributes Legal Entity's comprehensive income to NCI under the guidance in section 7.5.10 – i.e. the promissory notes affect the attribution.

When the promissory notes are repaid, Enterprise increases NCI.

Example 7.5.130
Sale of redeemable NCI while maintaining control – formula-based redemption amount

This example illustrates the accounting for a decrease in the parent's ownership interest while maintaining control when the NCI is redeemable.

In this example, the parent's ownership interest decreases because the subsidiary issues common shares to other investors. The accounting illustrated also applies to transactions in which a parent's ownership interest decreases while maintaining control due to:

- the parent selling a portion of its holdings in a subsidiary to other investors; or
- the subsidiary reacquiring a portion of its outstanding equity shares from its parent.

Background

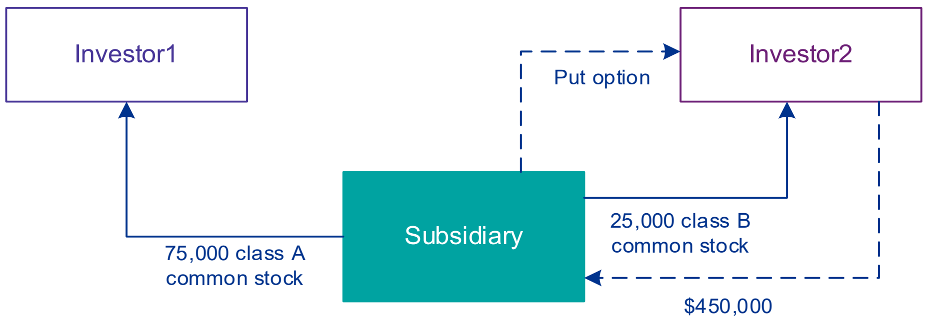
Subsidiary has 75,000 shares of Class A common stock outstanding, all of which are owned by its parent, Investor1.

On January 1, Year 1, Subsidiary issues 25,000 shares of Class B common stock to Investor2, an unrelated investor, for $450,000. The transaction reduces Investor1's ownership from 100% to 75%.

Immediately before the sale, the carrying amount (book value) of Subsidiary's equity is $1.0 million, which includes $40,000 in AOCI.

The Class A and B common shares are identical in all respects, except that the Class B common shares contain an embedded put option that allows Investor2 to require Subsidiary to repurchase its Class B shares on the seventh anniversary after the acquisition date.

The strike price of the embedded put option is determined based on a fixed multiple of Subsidiary's trailing revenue. The redemption formula is not at fair value or designed to equal or reasonably approximate fair value.



Investor1's Section 480-10-S99 accounting policies are provided in the following table.

Subsequent measurement (see Question 7.5.120)	Recognize changes in redemption amount immediately as they occur – i.e. adjust the carrying amount of the instrument to its current redemption amount at each reporting date.
Recognize adjustments to redeemable instruments (see Question 7.5.130)	— Classify adjustments that affect the numerator of the parent's EPS calculations under the two-class method as increases or decreases to retained earnings. — Classify adjustments that do not affect EPS as increases or decreases to APIC.
Recognize incremental adjustments to carrying amount of redeemable NCI in form of common interests (see Question 7.5.130)	Reflect adjustments directly in EPS calculations to the extent they increase or decrease the numerator. Do not include those adjustments in the attribution of comprehensive income to the parent and NCI.

Evaluation

Initial measurement

The NCI is initially measured at $362,500 at the January 1, Year 1 issuance date as shown in the following table.

Book value of Subsidiary equity (pre-transaction)	$1,000,000
Plus proceeds from Investor2	450,000
Book value of Subsidiary (post-transaction)	1,450,000
Percentage purchased by Investor2	× 25%
NCI measurement at acquisition (Subtopic 810-10 value) (A)	$ 362,500
Fair value of NCI at acquisition (B)	450,000
Excess acquisition-date fair value of NCI over Subtopic 810-10 measurement amount (B - A)	$ 87,500

The $87,500 excess of cash received over the amount recognized for the redeemable NCI is recognized as an increase to Investor1's APIC – i.e. no gain is recorded in the income statement (see Question 7.5.160).

Further, Investor1 reduces its AOCI and increases APIC by $10,000. This represents the carrying amount of Subsidiary's AOCI related to the ownership interest sold to the NCI holders ($40,000 × 25% = $10,000).

The following journal entry is recorded to reflect the sale of Subsidiary's redeemable NCI to Investor2.

	Debit	*Credit*
Cash	450,000	
AOCI (Investor1)	10,000	
NCI		362,500
APIC (Investor1)		97,500
To record issuance of Subsidiary's shares under Subtopic 810-10.		

Subsequent measurement – March 31, Year 1

The redemption amount of the redeemable NCI is $550,000.

During the interim period, Subsidiary's net income (loss) and OCI are as shown in the following table.

Net income (loss)	OCI (loss)	Comprehensive income (loss)
$320,000	$(20,000)	$300,000
		Attribution
	Controlling interest (75%)	$225,000
	NCI (25%)	$ 75,000

The fair value of the underlying NCI shares (excluding the redemption feature) is $540,000.

During the interim period, Subsidiary's net income (loss) and OCI are attributed to the 25% NCI under Subtopic 810-10 as shown in the following table.

Table 1				
Year 1	**Net income (loss) to NCI**	**OCI (loss) to NCI**	**Comprehensive income (loss) to NCI**	**NCI Subtopic 810-10 value**
Jan 1 (acquisition)				$362,500
Mar 31	$80,000	$(5,000)	$75,000	$437,500

EPS

The NCI is in the form of common interests (Class B common stock) and the redemption formula is based on a fixed multiple of trailing revenue, which is not a fair value redemption.

Investor1 does not include Section 480-10-S99 adjustments in the attribution of net income (loss) and OCI to the parent and NCI. As a result, it must apply the two-class method for computing EPS to determine how much of the Section 480-10-S99 adjustment affects the numerator of EPS calculations and is charged to retained earnings.

We believe there are two acceptable approaches in this scenario for determining the numerator adjustment for Investor 1's EPS calculation under the two-class method: the gross changes approach and the kicker approach.

Gross changes approach	Investor1 adjusts the numerator of its EPS calculations to reflect the increase (decrease) in any excess of the Section 480-10-S99 value amount over the Subtopic 810-10 value. The $87,500 difference between the NCI's initial Subtopic 810-10 carrying amount ($362,500) and its fair value at initial recognition ($450,000) does not affect the numerator of EPS calculations for the period (see Question 7.5.160).
Kicker approach	Investor1 adjusts the numerator of its EPS calculations to reflect the increase (decrease) in any excess of the Section 480-10-S99 value over the greater of — the Subtopic 810-10 value; and — the fair value of the NCI.

Gross changes approach

The following table shows for the redeemable NCI for each interim period of Year 1:

— the Subtopic 810-10 value;
— any excess of the Section 480-10-S99 value over the Subtopic 810-10 value; and
— the change in the excess from the prior period.

This information is necessary to determine the EPS numerator adjustment under the gross changes approach.

Table 2					
Year 1	Subtopic 810-10 value (A)	Section 480-10-S99 value (B)	Carrying amount (greater of A and B)	B - A	Increase (decrease) in B - A
Jan 1 (acquisition)	$362,500				
Mar 31	$437,500	$550,000	$550,000	$112,500	$112,500

Kicker approach

The following table determines the EPS numerator adjustment under the kicker approach by comparing the Subtopic 810-10 value, the fair value and the Section 480-10-S99 value of the redeemable NCI.

Table 3						
Year 1	Subtopic 810-10 value (A)	Fair value (B)	Greater of A and B (C)	Section 480-10-S99 value (D)	D in excess of C	Increase (decrease) in any excess of D over C
Jan 1 (acquisition)	$362,500					
Mar 31	$437,500	$540,000	$540,000	$550,000	$10,000	$10,000

Comparing the gross changes and kicker approaches

The following table summarizes the adjustments to the numerator of EPS under the two-class method for the interim period using the gross changes approach and the kicker approach. Calculations of these amounts are presented in the previous two tables.

Table 4		
Year 1	Charges (credits) to numerator of EPS calculations	
	Gross changes approach (Table 2)	Kicker approach (Table 3)
Mar 31	$ 25,000[1]	$ 10,000

Note:

1. Calculated at initial measurement as the difference between $112,500 (Table 2) and $87,500 ($450,000 excess acquisition-date fair value of NCI less $362,500 Subtopic 810-10 measurement amount).

March 31, Year 1

— Subsidiary's comprehensive income is $300,000, which is allocated $225,000 (75%) to Investor1 (parent) and $75,000 (25%) to the NCI (Table 2).

— The resulting measurement of the NCI under Subtopic 810-10 is $437,500 (Table 1).

- Under Section 480-10-S99, the NCI is measured at $550,000. This amount is $25,000 more than the Subtopic 810-10 value at the reporting date (Table 2).
- Investor1 measures the NCI at $550,000, which is the greater of the Subtopic 810-10 value and the Section 480-10-S99 value (Table 3).

If Investor1 uses the kicker approach in applying the two-class method (Table 3), it records the following journal entry at March 31, Year 1. This entry is made after allocating comprehensive income for the period between parent and NCI.

	Debit	*Credit*
Retained earnings	10,000	
APIC	102,500	
NCI		112,500
To increase carrying amount of NCI to its measurement amount under Section 480-10-S99.		

If Investor1 used the gross changes approach (Table 2), it would recognize $25,000 of the adjustment in retained earnings and $87,500 in APIC. The $87,500 is the difference between the redeemable NCI's initial measurement under Subtopic 810-10 and its fair value. That initial difference does not affect EPS for the period.

The entire $550,000 redeemable NCI balance as of March 31, Year 1 is presented in temporary equity.

Example 7.5.140
Acquisition of redeemable NCI while maintaining control – formula-based redemption amount

This example illustrates the accounting for an increase in the parent's ownership interest while maintaining control when the NCI is redeemable. In this example, the parent's ownership interest increases because the parent purchases shares in the subsidiary from other investors.

However, the accounting illustrated also applies to transactions in which a parent's ownership interest increases while maintaining control due to:

- the parent acquiring additional shares from a subsidiary; or
- the subsidiary reacquiring a portion of its outstanding equity shares from holders of NCI.

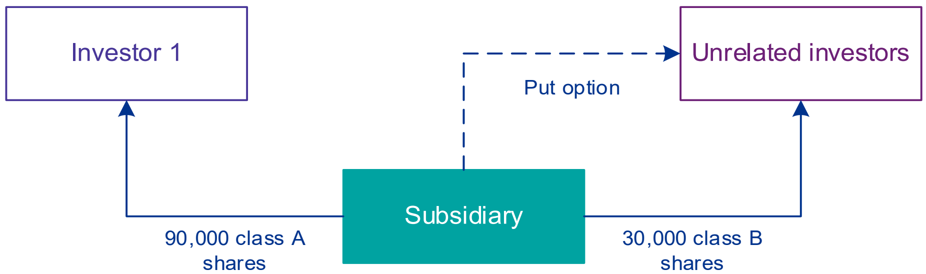
Background

Subsidiary has 120,000 common shares outstanding, consisting of 90,000 Class A shares (75% of all outstanding common shares) and 30,000 Class B shares (25% of all outstanding common shares).

Investor1, its parent, owns all of the Class A shares and the 30,000 Class B shares are held by unrelated investors.

The Class A and B common shares are identical in all respects, except that the Class B shares contain an embedded put option that gives the unrelated investors the ability to require Subsidiary to purchase the Class B shares on specified future dates.

The strike price of that embedded put option is determined based on a fixed multiple of Subsidiary's trailing EBITDA. The redemption formula is not at fair value or designed to equal or reasonably approximate fair value.



Investor1's Section 480-10-S99 accounting policies are provided in the following table.

Subsequent measurement (see Question 7.5.120)	Recognize changes in redemption amount immediately as they occur – i.e. adjust the carrying amount of the instrument to its current redemption amount at each reporting date.
Recognize adjustments to redeemable instruments (see Question 7.5.130)	— Classify adjustments that affect the numerator of the parent's EPS calculations under the two-class method as increases or decreases to retained earnings. — Classify adjustments that do not affect EPS as increases or decreases to APIC.
Recognize incremental adjustments to carrying amount of redeemable NCI in form of common interests (see Question 7.5.130)	Reflect adjustments directly in EPS calculations to the extent they increase or decrease the numerator. Do not include those adjustments in the attribution of comprehensive income to the parent and NCI.

On January 1, Year 1, when the redemption price of the Class B shares is $25 per unit, one of the NCI holders exercises its put option. Subsidiary reacquires 20,000 of its Class B shares (representing 2/3 of the shares held by NCI) from that NCI holder for $500,000 cash.

Subsidiary's reacquisition of 20,000 Class B shares increases Investor1's ownership interest in Subsidiary from 75% to 90% (90,000 Class A shares owned by Parent ÷ 100,000 issued shares).

Immediately before the share repurchase, the measurement amount of the NCI in Subsidiary under Subtopic 810-10 is $600,000, which included $30,000 in AOCI.

The measurement amount under Section 480-10-S99 is $750,000 – i.e. $25 per Class B unit.

As a result, the carrying amount of the redeemable NCI is carried at the greater of the two amounts (i.e. its Section 480-10-S99 value) and $750,000 (see Question 7.5.120) just before the share repurchase.

Evaluation

Subsidiary's reacquisition of shares held by the NCI interest is accounted for as an equity transaction in the consolidated financial statements of Investor1.

Under Subtopic 810-10 and Section 480-10-S99, the NCI is reduced by $500,000, which is the sum of (see Question 7.5.150):

— $400,000 (reduction based on the guidance in Subtopic 810-10: $600,000 Subtopic 810-10 value × the 2/3 reduction in shares held by the NCI); plus

— $100,000 (reduction for the excess Section 480-10-S99 value over the Subtopic 810-10 value (($750,000 - $600,000) × 2/3 reduction in shares held by the NCI).

The $500,000 reacquisition price is the $500,000 carrying amount of the 2/3 of the NCI immediately before the transaction.

As a result, the only adjustment to Investor1's APIC relates to the $20,000 increase in AOCI attributable to Parent as a result of the transaction ($30,000 × 2/3 = $20,000).

Investor1 records the following journal entry in its consolidated financial statements to reflect Subsidiary's reacquisition of 2/3 of its redeemable NCI.

	Debit	*Credit*
NCI	500,000	
APIC (Investor1)	20,000	
Cash		500,000
AOCI (Investor1)		20,000
To record Subsidiary's repurchase of redeemable shares.		

The $250,000 redeemable NCI balance that remains after this transaction (representing 10% of Subsidiary's outstanding shares) continues to be presented in temporary equity.

EPS

The acquisition of redeemable NCI for an amount equal to its carrying amount under Section 480-10-S99 does not result in an adjustment to the numerator of EPS calculations. Further, adjustments to the numerator of EPS calculations that were recorded in prior periods are not reversed.

Note: If the transaction that increased Investor1's ownership interest occurred between reporting dates, a final measurement of the NCI would be performed under Subtopic 810-10 and Section 480-10-S99 immediately before the transaction. In that case, the final increase or decrease to the carrying amount of the NCI under Section 480-10-S99 would be reflected in the numerator of Investor1's EPS calculations based on its policy for applying the two-class method – i.e. the gross changes approach or the kicker approach (see Example 7.5.130).

Excerpt from ASC 810-10

>> Example 1: Changes in a Parent's Ownership Interest in a Subsidiary

55-4B The following Cases illustrate the application of the guidance in paragraph 810-10-45-23 on accounting for changes in a parent's ownership interest in a subsidiary:

a. Change results in recognition of noncontrolling interest (Case A)
b. Change results in increase in noncontrolling interest (Case B)
c. Change if entity has accumulated other comprehensive income (Case C).

>>> Case A: Change Results in Recognition of Noncontrolling Interest

55-4C Subsidiary A has 10,000 shares of common stock outstanding, all of which are owned by its parent, Entity ABC. The carrying amount of Subsidiary A's equity is $200,000. Entity ABC sells 2,000 of its shares in Subsidiary A to an unrelated entity for $50,000 in cash, reducing its ownership interest from 100 percent to 80 percent. That transaction is accounted for by recognizing a noncontrolling interest in the amount of $40,000 ($200,000 × 20 percent). The $10,000 excess of the cash received ($50,000) over the adjustment to the carrying amount of the noncontrolling interest ($40,000) is recognized as an increase in additional paid-in capital attributable to Entity ABC. If the parent is a **not-for-profit entity** (NFP), the $10,000 increase in additional paid-in capital in this Example is recognized instead as an increase in net assets, generally of the without donor restrictions class. Example 1 (see paragraphs 958-810-55-17 through 55-25) provides additional guidance for NFPs.

>>> Case B: Change Results in Increase in Noncontrolling Interest

55-4D Subsidiary A has 10,000 shares of common stock outstanding. Of those shares, 9,000 are owned by its parent, Entity ABC, and 1,000 are owned by other shareholders (a noncontrolling interest in Subsidiary A). The carrying amount of Subsidiary A's equity is $300,000. Of that amount, $270,000 is attributable to Entity ABC, and $30,000 is a noncontrolling interest in Subsidiary A. Subsidiary A issues 2,000 previously unissued shares to a third party for $120,000 in cash, reducing Entity ABC's ownership interest in Subsidiary A from 90 percent to 75 percent (9,000 shares owned by Entity ABC ÷ 12,000 issued shares).

55-4E Even though the percentage of Entity ABC's ownership interest in Subsidiary A is reduced when Subsidiary A issues shares to the third party, Entity ABC's investment in Subsidiary A increases to $315,000, calculated as 75 percent of Subsidiary A's equity of $420,000 ($300,000 + $120,000). Therefore, Entity ABC recognizes a $45,000 increase in its investment in Subsidiary A ($315,000 – $270,000) and a corresponding increase in its additional paid-in capital (that is, the additional paid-in capital attributable to Entity ABC). In addition, the noncontrolling interest is increased to $105,000, calculated as 25 percent of $420,000. If the parent is an NFP, the $45,000 increase in additional paid-in capital in this example is recognized instead as an increase in net assets, generally of the without donor restrictions class. Example 1 (see paragraphs 958-810-55-17 through 55-25) provides additional guidance for NFPs.

>>> Case C: Change if Entity Has Accumulated Other Comprehensive Income

55-4F Subsidiary A has 10,000 shares of common stock outstanding. Of those shares, 8,000 are owned by its parent, Entity ABC, and 2,000 are owned by other shareholders (a noncontrolling interest in Subsidiary A). The carrying amount of the noncontrolling interest is $48,000, which includes $4,000 of AOCI. Entity ABC pays $30,000 in cash to purchase 1,000 shares held by the noncontrolling shareholders (50 percent of the noncontrolling interest), increasing its ownership interest from 80 percent to 90 percent. That transaction is recognized by reducing the carrying amount of the noncontrolling interest by $24,000 ($48,000 × 50 percent). The $6,000 excess of the cash paid ($30,000) over the adjustment to the carrying amount of the noncontrolling interest ($24,000) is recognized as a decrease in additional paid-in capital attributable to Entity ABC. In addition, Entity ABC's share of AOCI is increased by $2,000 ($4,000 × 50 percent) through a corresponding decrease in additional paid-in capital attributable to Entity ABC.

Question 7.5.170

How does a parent account for costs relating to transactions with the NCI holder(s) while retaining control?

Interpretive response: We believe the parent may make a policy election to recognize transaction costs in equity or in net income. The policy must be consistently applied and disclosed if material. [250-10-45-1]

Subtopic 810-10 is not clear on the treatment of transaction costs associated with transactions with NCI while retaining control. It states that transactions with NCI while retaining control are accounted for as equity transactions. This guidance suggests that transaction costs are included in equity. [810-10-45-23]

Subtopic 810-10 also states that any difference between the fair value of the consideration paid and the amount by which the NCI is adjusted is recognized in equity attributable to the parent. This guidance suggests that transaction costs are expensed as incurred because they are not an element of the fair value of the consideration paid. [810-10-45-23]

If a parent includes transaction costs in net income, the related payments are cash outflows for operating activities. If it includes them in equity, they are cash flows from financing activities. See section 19.4 of KPMG Handbook, Statement of cash flows, for additional discussion.

Question 7.5.180

Does a parent reverse previous adjustments that it made to temporary equity when redeemable NCI is redeemed or transferred?

Background: Redeemable NCI is classified as temporary equity if the redemption provision has certain characteristics (see Question 8.2.10).

As discussed in Question 8.2.70, on the date the NCI no longer meets the conditions to be presented as temporary, the parent reclassifies its carrying amount to permanent equity but does not: [480-10-S99-3A.18]

- adjust the presentation of the NCI in its prior-period financial statements; or
- reverse any changes to the NCI's carrying amount that were recognized as a result of the redemption feature (see section 7.5.20).

Interpretive response: Yes. The adjustment(s) the parent makes (or made) while the NCI is (or was) presented as temporary remain as a component of the NCI's carrying amount until the parent increases its ownership percentage (i.e. NCI is reduced) or the subsidiary is deconsolidated.

- If the parent increases its ownership percentage, it reduces the total adjustment in proportion to the reduction in the NCI.
- If the parent deconsolidates the subsidiary or redeems the formerly redeemable NCI, it eliminates the entire adjustment (see Question 7.6.100).

The parent recognizes the reduction or elimination of the adjustment through a credit to equity attributable to the parent's controlling interest.

Question 7.5.190

How does a downstream merger affect NCI?

Background: In a downstream merger, a subsidiary exchanges its common shares for the outstanding voting common shares of its parent. This type of transaction is sometimes used to effect the acquisition of NCI.

Interpretive response: A downstream merger is accounted for as if the parent acquired NCI with an issuance of its common stock.

Whether a parent technically acquires the NCI of a subsidiary, or the subsidiary technically acquires its parent, the transaction results in a single stockholder group owning the consolidated net assets. The same result could have been achieved by setting up a new entity that issues its common shares in exchange for the common shares of the parent and the common shares of the subsidiary held by the NCI holder(s).

For example, Parent owns 70% of the outstanding voting common shares of Subsidiary. A downstream merger is planned whereby Subsidiary will acquire the assets of Parent.

The transaction is accounted for as if Parent had exchanged its common shares for the NCI in Subsidiary. Subsidiary (the survivor entity) adjusts its accounts to reflect any difference between:

— Parent's equity; and
— Parent's investment in Subsidiary.

Further, Subsidiary adjusts its shareholders' equity to reflect the shareholders' equity of Parent, after giving effect to the acquisition of the former NCI.

The acquisition of the former NCI is reflected as an equity transaction. The difference between the fair value of the consideration paid and the carrying amount of the NCI being eliminated is recognized as an adjustment to APIC.

If the resulting balance of APIC is less than the par amount (or stated value) of the capital stock of the survivor entity, an appropriate reclassification is made from retained earnings.

7.6 Deconsolidation

7.6.10 Procedure

Excerpt from ASC 810-10

General

> Implementation Guidance

>> Scope Application to Deconsolidation of a Subsidiary

55-1A This Subtopic provides guidance for deconsolidation of a **subsidiary**. If an asset one entity transfers to a second entity in exchange for a **noncontrolling interest** in that second entity is a subsidiary, the gain or loss of a controlling financial interest in that subsidiary is accounted for in accordance with this Subtopic.

> Deconsolidation of a Subsidiary or Derecognition of a Group of Assets

40-3A The deconsolidation and derecognition guidance in this Section applies to the following:

a. A subsidiary that is a **nonprofit activity** or a business, except for either of the following:
    1. Subparagraph superseded by Accounting Standards Update No. 2017-05
    2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360)
    3. A transfer of a good or service in a **contract** with a **customer** within the scope of Topic 606.

b. A group of assets that is a nonprofit activity or a business, except for either of the following:
    1. Subparagraph superseded by Accounting Standards Update No. 2017-05
    2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360)
    3. A transfer of a good or service in a contract with a customer within the scope of Topic 606.

c. A subsidiary that is not a nonprofit activity or a business if the substance of the transaction is not addressed directly by guidance in other Topics that include, but are not limited to, all of the following:
    1. Topic 606 on **revenue** from contracts with customers
    2. Topic 845 on exchanges of nonmonetary assets
    3. Topic 860 on transferring and servicing financial assets
    4. Topic 932 on conveyances of mineral rights and related transactions
    5. Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

40-3B Paragraph superseded by Accounting Standards Update No. 2017-05.

40-4 A parent shall deconsolidate a subsidiary or derecognize a group of assets specified in paragraph 810-10-40-3A as of the date the parent ceases to have a controlling financial interest in that subsidiary or group of assets. See paragraph 810-10-55-4A for related implementation guidance.

40-4A When a parent deconsolidates a subsidiary or derecognizes a group of assets within the scope of paragraph 810-10-40-3A, the parent relationship ceases to exist. The parent no longer controls the subsidiary's assets and liabilities or the group of assets. The parent therefore shall derecognize the assets, liabilities, and equity components related to that subsidiary or group of assets. The equity components will include any noncontrolling interest as well as amounts previously recognized in accumulated other comprehensive income. If the subsidiary or group of assets being deconsolidated or derecognized is a **foreign entity** (or represents the complete or substantially complete liquidation of the foreign entity in which it resides), then the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that foreign entity. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

40-5 If a parent deconsolidates a subsidiary or derecognizes a group of assets through a **nonreciprocal transfer** to **owners**, such as a spinoff, the accounting guidance in Subtopic 845-10 applies. Otherwise, a parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:

a. The aggregate of all of the following:
    1. The fair value of any consideration received
    2. The fair value of any retained noncontrolling investment in the former

subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized

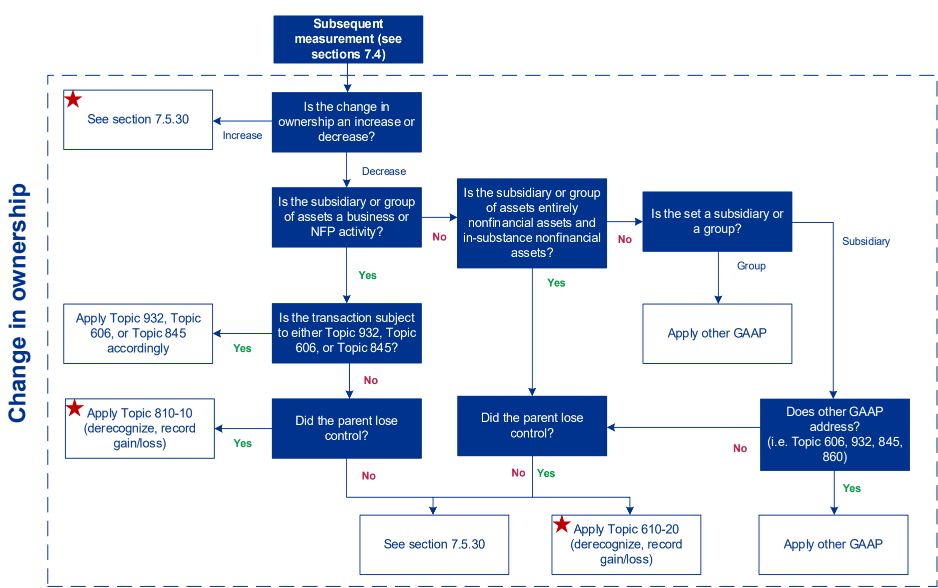
3. The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated.

b. The carrying amount of the former subsidiary's assets and liabilities or the carrying amount of the group of assets.

40-6 A parent may cease to have a controlling financial interest in a subsidiary through two or more arrangements (transactions). Circumstances sometimes indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all of the terms and conditions of the arrangements and their economic effects. Any of the following may indicate that the parent should account for the multiple arrangements as a single transaction:

a. They are entered into at the same time or in contemplation of one another.
b. They form a single transaction designed to achieve an overall commercial effect.
c. The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
d. One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

The following diagram summarizes how a parent accounts for changes in ownership of a subsidiary. This section addresses deconsolidation. For discussion on changes in ownership in which the parent retains control, see section 7.5.30.



At the point in time that a parent loses a controlling financial interest in a subsidiary, it stops consolidating the subsidiary and derecognizes the subsidiary's assets, liabilities and equity components (e.g. NCI and AOCI). The deconsolidation requirements are the same for both VOEs and VIEs. [810-10-40-4 – 40-4A]

Question 7.6.10

Generally, how is deconsolidation accounted for?

Interpretive response: A former parent (now investor) begins applying the equity method if it has the ability to exercise significant influence over the former subsidiary (now investee). If not, the investor accounts for the investee under Topic 321 (equity securities).

The following table provides an overview of the guidance applicable to deconsolidation. The accounting depends on the nature of the subsidiary.

Type of subsidiary	Overview of derecognition guidance	Reference
Subsidiary or group of assets is a business or nonprofit activity	The investor deconsolidates the subsidiary under Subtopic 810-10 by removing its net assets and recognizing a gain or loss in net income.	Question 7.6.20
Subsidiary is not a business and holds only nonfinancial assets and in-substance nonfinancial assets	The investor deconsolidates the subsidiary under Subtopic 610-20 by removing its net assets and recognizing a gain or loss in net income.	Question 7.6.40
Other subsidiaries	An investor applies other guidance if the transaction is a: — conveyance of oil and gas mineral rights: apply Subtopic 932-360 (oil and gas); — transfer of a good or service in a contract with a customer: apply Topic 606 (revenue); — nonmonetary exchange: apply Topic 845 (nonmonetary transactions); or — transfer of a financial asset: apply Topic 860 (transfers and servicing).	Question 7.6.60

If a parent anticipates deconsolidating a subsidiary, it needs to evaluate whether held-for-sale and/or discontinued operations presentation under Subtopic 205-20 is appropriate. See KPMG Handbook, Discontinued operations and held-for-sale disposal groups.

Question 7.6.20

How does a parent deconsolidate a subsidiary or a group of assets that is a business or nonprofit activity?

Interpretive response: The loss by a parent of a controlling financial interest in a subsidiary is a significant economic event that causes the parent-subsidiary relationship to cease and an investor-investee relationship to begin.

When a deconsolidation is of a subsidiary or a group of assets that is a business or a nonprofit activity, it is accounted for under Subtopic 810-10 unless a scope exception applies (see Question 7.6.60). That guidance requires that the parent deconsolidate the subsidiary by: [810-10-40-3A – 4A]

- removing the assets, liabilities and equity components (including NCI and AOCI) related to the subsidiary; and
- recognizing a gain or loss in net income.

The gain or loss on deconsolidation is measured as the difference between: [810-10-40-5]

- the aggregate of:
  - the fair value of the consideration received;
  - the fair value of any retained NCI in the former subsidiary at the date of deconsolidation;
  - the carrying amount of the NCI (excluding adjustments related to redeemable NCIs) in the former subsidiary (including AOCI attributable to the NCI) at the date of deconsolidation; and
- the carrying amount of the former subsidiary's assets and liabilities.

The fair value of the retained NCI in the former subsidiary becomes the investor's cost basis in its retained equity interest. See section 6 of KPMG Handbook, Equity method of accounting, for additional discussion on transitioning from consolidation to the equity method.

While an investor typically presents its gain or loss on sale in continuing operations, the deconsolidation of a subsidiary may qualify for discontinued operations presentation. See KPMG Handbook, Discontinued operations and held-for-sale disposal groups.

Example 7.6.10

Gain or loss recognized on deconsolidation of a subsidiary

Background

Parent owns 60% of the shares of Subsidiary (a business).

On January 1, Year 1, Parent sells 20% of its interest in Subsidiary for $500 and loses its controlling financial interest in Subsidiary.

At the sale date:

- the carrying amount of Subsidiary's net assets in the consolidated financial statements is $1,850;
- the equity attributable to the NCI is $700, which includes AOCI of $30;
- the equity attributable to Parent is $1,150, including AOCI of $45;
- the fair value of Parent's remaining 40% investment in Subsidiary is $1,000;
- Parent will account for its 40% retained interest using the equity method.

Evaluation

Parent's gain on deconsolidation of Subsidiary is computed in the following table.

Cash (fair value of consideration received)	$	500
Retained investment in Subsidiary at fair value		1,000
Equity:		
Carrying amount of NCI (including AOCI of $30)		700
		2,200
Less: Carrying amount of Subsidiary's net assets		1,850
Gain on sale		350
Reclassification of AOCI to earnings	$	45

Parent records the following journal entries to reflect the sale on January 1, Year 1.

	Debit	*Credit*
Cash	500	
Equity: NCI (including AOCI of $30)	700	
Retained equity method investment	1,000	
Net assets of Subsidiary (including goodwill)		1,850
Gain on sale of 20% interest in Subsidiary[1]		350
To record sale of partial interest in Subsidiary.		
AOCI	45	
Net income[2]		45
To reclassify AOCI attributable to Parent to net income.		

Notes:

1. The gain comprises:
   - a $234 ($1,000 – (40% ÷ 60% × $1,150) remeasurement to fair value of Parent's retained 40% investment; plus
   - a $116 ($500 – (20% ÷ 60% × $1,150) gain on the sale of the 20% interest.
2. This amount is classified in the income statement based on the nature of its components.

If the remaining interest of 40% is accounted for under the equity method, the fair value of $1,000 is its cost on initial recognition. Parent applies Topic 323 from the sale date forward.

When the retained interest is accounted for by the equity method, the former parent is required to perform a memo purchase price allocation related to its equity method investment in accordance with Topic 323.

See chapter 3 of KPMG Handbook, Equity method of accounting, for a discussion on the initial recognition and measurement of equity method investments.

Question 7.6.30

How does the parent account for contingent consideration received in the sale of a business?

Background: Topic 805 addresses the *acquirer's* accounting for contingent consideration transferred to a seller (i.e. former parent of the subsidiary) in a business combination. However, it does not address the *seller's* accounting for contingent consideration received in the sale of a business.

Interpretive response: We believe a seller (former parent) can recognize contingent consideration that is not accounted for as a derivative either:

— at fair value at the sale date; or
— when the contingency is resolved under Topic 450.

We believe these accounting policy alternatives are acceptable based on the current diversity in practice. However, we believe the policy should be consistently applied and disclosed.

Question 7.6.40

How does a parent deconsolidate a subsidiary that is not a business?

Interpretive response: If the subsidiary is not a business, the nature of the assets within the subsidiary guides which US GAAP to apply.

Subsidiary is not a business and holds only nonfinancial assets and in-substance nonfinancial assets

If the subsidiary holds only nonfinancial assets and in-substance nonfinancial assets, the parent applies Subtopic 610-20 (other income) to the deconsolidation transaction.

That Subtopic requires that the parent deconsolidate the subsidiary by: [610-20-32-3 – 32-5]

— removing the assets, liabilities and equity components (including NCI and AOCI) related to the subsidiary; and
— recognizing a gain or loss in net income.

The gain or loss on deconsolidation is measured as the difference between: [610-20-32-3, 606-10-32-21, 323-10-30-2, 35-5, 35-13]

- the aggregate of:
  - the transaction price under Topic 606 (revenue);
  - the carrying amount of liabilities assumed by the buyer; and
- the carrying amount of the former subsidiary's assets and liabilities.

The transaction price under Topic 606 includes (as noncash consideration) the fair value of any retained ownership interest in the subsidiary. Fair value is measured at the contract inception date (or at the date control is lost; see Question 7.6.50) and becomes the investor's cost basis in its retained interest.

See section 6 of KPMG Handbook, Equity method of accounting, for additional discussion about transitioning from consolidation to the equity method. See section F of KPMG Handbook, Revenue: real estate, for additional discussion about applying Subtopic 610-20 to deconsolidating subsidiaries that are in its scope.

While an investor typically presents its gain or loss on sale in continuing operations, the deconsolidation of a subsidiary may qualify for discontinued operations presentation. See KPMG Handbook, Discontinued operations and held-for-sale disposal groups.

Other subsidiaries

If the subsidiary is not a business and does not hold only nonfinancial assets and in-substance nonfinancial assets, the parent applies other applicable US GAAP if that other GAAP addresses derecognition (see Question 7.6.60). If not, it applies Subtopic 810-10 (see Question 7.6.20).

Question 7.6.50

Does a parent always derecognize a subsidiary's net assets if it loses its controlling financial interest?

Interpretive response: No. A parent that loses its controlling financial interest in a subsidiary that is in the scope of Subtopic 610-20 derecognizes the subsidiary's net assets only if it also transfers control of the subsidiary's underlying assets and extinguishes its underlying liabilities.

Subtopic 610-20 requires a parent to analyze deconsolidation of the subsidiary in two steps. [610-20-25-2 – 25-7]

Step 1	Parent evaluates whether it has lost its controlling financial interest under Subtopic 810. — If the parent retains its controlling financial interest, it does not derecognize the assets (see section 7.5.30). — If the parent loses its controlling financial interest, it goes to Step 2.
Step 2	Parent evaluates whether it meets the derecognition requirements under Subtopic 610-20 for each distinct asset in the subsidiary. Subtopic 610-20 requires the parent to use the principles in Topic 606 to determine if the parent has a contract with the buyer and has transferred control of the assets.

Evaluating transfer of control of the assets under Subtopic 610-20

Subtopic 610-20 describes how to apply the principles in Topic 606 in different scenarios. [610-20-25-6 – 25-7, 55-15 – 55-16]

Former parent retains an NCI	Former parent does not retain an NCI
When the former parent retains an NCI in the former subsidiary, the parent derecognizes each of the distinct assets when that former subsidiary controls those assets. The former subsidiary controls those assets when it can direct the use of, and obtain substantially all of the benefits from, each distinct asset. Most partial ownership sales result in gain recognition when the parent relinquishes its controlling financial interest in the subsidiary. However, if the parent retains rights that constrain the subsidiary's ability to control the assets (e.g. retains a call option), control may not transfer until those rights expire.	When the former parent does not retain an NCI in the former subsidiary, the parent derecognizes each of the distinct assets when the buyer (or buyers) controls the assets. The buyer controls the assets when it can direct the use of, and obtain substantially all of the benefits from, each distinct asset.

Subtopic 610-20 applies to a deconsolidation transaction if the subsidiary holds only nonfinancial assets and in-substance nonfinancial assets (see Question 7.6.40). See KPMG Handbook, Revenue: Real estate, for additional discussion on applying Subtopic 610-20.

Question 7.6.60

What types of deconsolidation transactions are outside the scope of Subtopics 810-10 and 610-20?

Interpretive response: In addition to transactions in the scope of Subtopic 610-20 (Question 7.6.40), Subtopic 810-10 excludes other derecognition transactions from its scope, as indicated in the following table. [810-10-40-3A, 40-5]

	Excluded from or included in 810 scope when subsidiary is:		
Subtopic 810-10 scope exceptions	**Business/ nonprofit**	**Not a business/ nonprofit[2]**	**When excluded from 810, what Topic applies?**
Conveyance of oil and gas mineral rights	Excluded	Excluded	Subtopic 932-360 (oil and gas)
Transfer of a good or service in a contract with a customer	Excluded	Excluded	Topic 606 (revenue)
Nonmonetary exchange	Included[1]	Excluded	Topic 845 (nonmonetary exchanges)
Transfer of a financial asset	Included	Excluded	Topic 860 (transfers and servicing)

Notes:

1. Subtopic 810-10 does not apply to the deconsolidation of a subsidiary through a nonreciprocal transfer to owners – e.g. as a spinoff. [810-10-40-5]
2. A subsidiary that is not a nonprofit activity or a business is excluded from the scope of Subtopic 810-10 only if the substance of the transaction is addressed directly by guidance in other Topics. If not addressed by another topic, Subtopic 810-10 applies.

The above exclusions to the deconsolidation provisions in Subtopic 810-10 do not apply to transactions in which a parent increases its ownership interest in a subsidiary. Instead, the requirements discussed in section 7.5.30 apply to those transactions.

Question 7.6.70

Does a parent include in its gain or loss on disposal APIC from prior transactions?

Interpretive response: No. On disposal, the parent derecognizes the assets, liabilities and equity components related to the subsidiary. [810-10-40-4 – 40-5]

Equity components related to the subsidiary	
Include in gain or loss on disposal	**Do not include in gain or loss on disposal**
Any NCI as well as amounts recognized in AOCI.	Amounts recorded outside of OCI – e.g. those related to changes in ownership interests that did not result in a loss of control.

Question 7.6.80

How does a parent account for the transfer of a subsidiary to an equity method investee?

Interpretive response: It depends. If the transfer is in the scope of Subtopic 810-10 or Subtopic 610-10, and the parent qualifies for derecognition under those standards, it recognizes the full gain in net income. In computing the gain, the former parent includes as consideration received the fair value of the retained interest in the former subsidiary. [810-10-40-5, 610-10-32-2 – 32-6, 323-10-35-7]

However, if the investee is a customer, the derecognition transaction is in the scope of Topic 606. In that case, Topic 323 generally requires the parent to eliminate intra-entity profit until it is realized through sale. [323-10-35-7]

See chapter 5 of KPMG Handbook, Equity method of accounting, for additional discussion of accounting for intra-entity transactions with equity method investees.

Question 7.6.90

What are some indicators that multiple arrangements are indicative of a single loss-of-control transaction?

Interpretive response: A parent may lose its controlling financial interest in a subsidiary as a result of more than one transaction. Circumstances may indicate that the multiple transactions must be accounted for as a single transaction. In making this determination, a parent considers:

— all of the terms and conditions of the transactions; and
— their economic effects.

Any of the following may indicate that a parent should account for multiple transactions as a single transaction: [810-10-40-6]

Time	They are entered into at the same time or in contemplation of one another.
Commercial effect	They form a single transaction designed to achieve an overall commercial effect.
Interdependence	The occurrence of one arrangement depends on the occurrence of at least one other arrangement.
Economic justification	One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

Subtopic 810-10 provides a list of indicators to be considered, instead of detailed examples. In some instances, it will be clear that a series of transactions are linked and should be accounted for as a single transaction. In other cases, judgment is necessary in making the determination. In general, we believe the less time there is between transactions the more likely it is that the transactions should be combined for accounting purposes.

The requirement for a parent to recognize a gain or loss at the point in time of the deconsolidation transaction could motivate it to structure the arrangement into multiple steps to maximize gains or minimize losses. However, its ability to take advantage of this type of structuring is reduced by the requirement to determine whether multiple arrangements represent a single transaction.

Example 7.6.20
Multiple transactions

Background

Parent has a 70% controlling financial interest in Subsidiary, which it intends to sell in its entirety.

Parent considers two options for achieving deconsolidation.

— Option 1: Parent could initially sell 19% of its ownership interest in Subsidiary without loss of control and then, soon afterwards, sell the remaining 51% and lose control.

— Option 2: Parent could sell all of its 70% interest in Subsidiary in one transaction.

Evaluation: Option 1

Unless the transactions are determined to be linked (Question 7.6.90), the gain or loss on the sale of the 19% interest is recognized in equity (see section 7.5.30). The gain or loss from the sale of the remaining 51% interest is recognized in net income.

If the transactions are determined to be linked, the accounting is the same as Option 2.

Evaluation: Option 2

The gain or loss on the sale of the 70% interest is recognized in net income.

Question 7.6.100
How does a parent account for previous adjustments made to an NCI presented in temporary equity in a deconsolidation transaction?

Background: Redeemable NCI is classified as temporary equity if the redemption provision has certain characteristics (see Question 8.2.10).

As discussed in Question 8.2.70, on the date the NCI no longer meets the conditions to be presented as temporary, the parent reclassifies its carrying amount to permanent equity but does not: [480-10-S99-3A.18]

- adjust the presentation of the NCI in its prior-period financial statements; or
- reverse any changes to the NCI's carrying amount that were recognized as a result of the redemption feature (see section 7.5.20).

Interpretive response: Section 480-10-S99 specifies that the carrying amount of NCI when determining the gain or loss on deconsolidation is its carrying amount under Subtopic 810-10 – i.e. the gain or loss on deconsolidation is not affected by the Section 480-10-S99 adjustments. [480-10-S99-3A.19, 810-10-40-5]

Previously recognized adjustments to the carrying amount of NCI under Section 480-10-S99 are eliminated in the same manner in which they were initially recognized – i.e. by reversing them through an adjustment to the equity of the parent. Section 480-10-S99 does not specify whether the parent should increase the numerator in its EPS computations as a result of eliminating these adjustments on deconsolidation. [480-10-S99-3A.19]

Disclosure of the amount credited to equity of the parent on deconsolidation of a subsidiary is encouraged.

See section 7.5.20 for discussion of the accounting for changes in the carrying amount of redeemable NCI.

Example 7.6.30

Deconsolidation – redeemable NCI in the subsidiary before sale (formula-based redemption amount)

This example illustrates the accounting for a decrease in a parent's ownership interest that results in it losing control and deconsolidating the subsidiary.

In this example, the parent's ownership interest decreases because the parent sells a portion of its holdings in the subsidiary to other investors. The accounting illustrated also applies to transactions in which a parent's ownership interest decreases resulting in a loss of control due to:

- the subsidiary issuing shares to other investors; or
- the subsidiary reacquiring a portion of its outstanding equity shares from its parent.

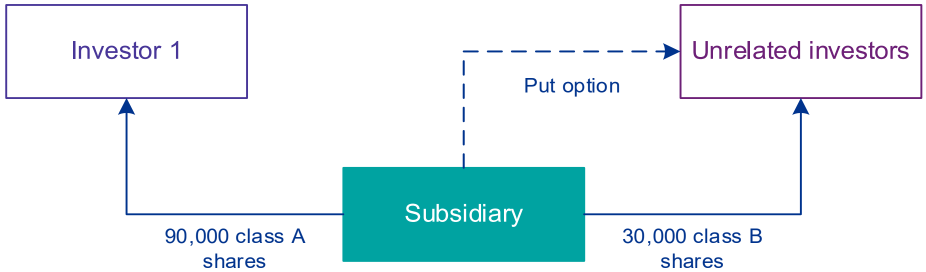
Background

Subsidiary (a business) has 120,000 common shares outstanding, consisting of 90,000 Class A shares (75% of all outstanding common shares) and 30,000 Class B shares (25% of all outstanding common shares).

Investor1, its parent, owns all of the Class A shares. The 30,000 Class B shares are held by unrelated investors.

The Class A and B common shares are identical in all respects, except that the Class B shares contain an embedded put option that allows the unrelated investors the ability to require Subsidiary to purchase the Class B shares on specified future dates.

The strike price of that embedded put option is determined based on a fixed multiple of Subsidiary's trailing EBITDA. The redemption formula is not at fair value or designed to equal or reasonably approximate fair value.



Investor1's Section 480-10-S99 accounting policies are provided in the following table.

Subsequent measurement (see Question 7.5.120)	Recognizes changes in redemption amount immediately as they occur – i.e. adjust the carrying amount of the instrument to its current redemption amount at each reporting date.
Recognize adjustments to redeemable instruments (see Question 7.5.130)	— Classify adjustments that affect the numerator of the parent's EPS calculations under the two-class method as increases or decreases to retained earnings. — Classify adjustments that do not affect EPS as increases or decreases to APIC.
Recognize incremental adjustments to carrying amount of redeemable NCI in form of common instruments (see Question 7.5.130)	Reflect adjustments directly in EPS calculations to the extent they increase or decrease the numerator. Do not include those adjustments in the attribution of comprehensive income to the parent and NCI.

On January 1, Year 1, Investor1 sells 66,000 Class A shares of Subsidiary to a group of unrelated investors for $2.4 million (approximately $36 per share), reducing its ownership interest in Subsidiary to 20% (24,000 Class A shares owned by Parent ÷ 120,000 issued shares). Investor1 loses its controlling financial interest in Subsidiary as a result of the sale and is required to deconsolidate.

NCI Immediately before the sale

The Subtopic 810-10 value is $600,000, which includes $30,000 in AOCI. The Section 480-10-S99 value is $750,000 – i.e. the formula-based redemption price of $25 per Class B share.

The carrying amount of the redeemable NCI is $750,000 – i.e. its Section 480-10-S99 value. This is because that amount exceeds the $600,000 Subtopic 810-10 value (Question 7.5.120).

The fair value of the underlying NCI shares (excluding the redemption feature) is $1.0 million.

Subsidiary's net assets in the consolidated financial statements are shown in the following table.

Identifiable assets	$2,300,000
Goodwill	$ 800,000
Liabilities	$ (900,000)
Net assets	$2,200,000

Immediately after the sale

The fair value of Investor1's remaining 24,000 Class A common shares is $700,000. Investor1 concludes that its remaining investment provides it with the ability to exercise significant influence over Subsidiary.

Evaluation

Previously recorded adjustments to the carrying amount of NCI from the application of Section 480-10-S99 are eliminated in the same manner in which they were initially recognized. In this example, those amounts are eliminated by adjusting the equity of Investor1 immediately before deconsolidating Subsidiary.

As a result, Parent reduces the $750,000 carrying amount of the NCI to $600,000 (its Subtopic 810-10 value) before calculating the gain or loss from the sale.

The calculation of Investor1's gain is included in the following table (see Question 7.6.20).

A	
Cash consideration received from the sale of 66,000 Class A common shares of Subsidiary	$2,400,000
Fair value of retained NCI in Subsidiary (24,000 Class A common shares)	700,000
Subtopic 810-10 value of NCI in Subsidiary (including the $30,000 of AOCI attributable to the NCI) immediately before deconsolidation	600,000
Total consideration (A)	$3,700,000
B	
Carrying amount of Subsidiary's assets and liabilities immediately before deconsolidation (B)	$2,200,000
Gain on sale (A – B)	$1,500,000

Investor1 records the following journal entries.

	Debit	*Credit*
NCI	150,000	
APIC (Investor1)		150,000
To eliminate previously recorded adjustments to measure NCI under Section 480-10-S99.		

	Debit	*Credit*
Cash	2,400,000	
NCI (Subtopic 810-10 value)	600,000	
Retained equity method investment	700,000	
Net assets of Subsidiary		2,200,000
Gain		1,500,000
To record sale of shares in, and deconsolidation of, Subsidiary.		
AOCI	30,000	
Net income[1]		30,000
To reclassify AOCI attributable to Parent to net income.		

Note:

1. This amount is classified in the income statement based on the nature of its components.

Because Investor1 concludes that its remaining investment in 24,000 shares of Class A common stock gives it the ability to exercise significant influence over the operating and financial policies of Subsidiary, it applies the equity method of accounting under Topic 323 to its investment after the sale.

Question 7.6.110

Does a parent recognize as an increase in its gain its negative investment in a subsidiary when it deconsolidates the subsidiary?

Interpretive response: It depends. We believe the negative investment is recognized as an increase to the gain on deconsolidation, unless the parent has a continuing legal obligation associated with the subsidiary's liabilities.

A former parent does not generally keep legal responsibility for the liabilities of its former subsidiary. However, it may if it:

— guarantees, or indemnifies the holders of, the liabilities of the subsidiary;
— is contractually secondarily liable or jointly liable for the liabilities of the subsidiary; or
— has otherwise committed to fund the liabilities of the subsidiary.

An assessment is needed to determine if a loss contingency needs to be recognized and/or disclosed for possible claims against the parent by the former subsidiary's creditors. We believe the amount of the negative investment reversed to gain is limited by the amount of any loss contingency liability recognized. [450-20-25-2]

The absence of a continuing legal obligation is typically demonstrated by obtaining written evidence from legal counsel. Other factors to consider include the following.

Factor	Effect on analysis
Is the parent discontinuing in its entirety the business that the former subsidiary conducted?	A complete discontinuance of that business (or geographic location) suggests that the parent is not committed to the subsidiary's liabilities.
Does the parent intend to regain control of the former subsidiary, reinvest directly in the former subsidiary, or invest in the business of the former subsidiary through other entities or operations?	Although the accounting does not depend on management's intentions, a parent's intention to continue the business of the former subsidiary suggests that the reversal of the negative investment may be premature.

Question 7.6.120

Does a transfer of a subsidiary between entities under common control result in a gain or loss in the transferor's financial statements?

Interpretive response: No. We believe no gain or loss should be recognized in a transfer of a subsidiary between entities under common control for the following reasons.

Topic 805 provides guidance for acquisitions between entities under common control. This guidance requires that the acquirer account for the transaction at carryover basis. It does not address the seller's accounting.

In a transfer of a subsidiary between two commonly controlled entities, the parent is effectively only reorganizing its existing businesses.

Example 7.6.40

Transfer of a subsidiary between entities under common control

Background

Subsidiary A and Subsidiary B are wholly owned subsidiaries of Parent.

Subsidiary A holds a 100% interest in Subsidiary C, which has a $100 carrying amount. Subsidiary A transfers 100% of Subsidiary C to Subsidiary B in exchange for $110.

Evaluation

Subsidiary A recognizes the $10 difference between the carrying amount and the proceeds received as an increase in equity – i.e. it is effectively treated as a net distribution from Subsidiary B to Parent and a net contribution from Parent to Subsidiary A.

7.6.20 Foreign currency considerations

Excerpt from ASC 810-10

General

> Deconsolidation of a Subsidiary or Derecognition of a Group of Assets

40-4A When a parent deconsolidates a subsidiary or derecognizes a group of assets within the scope of paragraph 810-10-40-3A, the parent relationship ceases to exist. The parent no longer controls the subsidiary's assets and liabilities or the group of assets. The parent therefore shall derecognize the assets, liabilities, and equity components related to that subsidiary or group of assets. The equity components will include any noncontrolling interest as well as amounts previously recognized in accumulated other comprehensive income. If the subsidiary or group of assets being deconsolidated or derecognized is a foreign entity (or represents the complete or substantially complete liquidation of the **foreign entity** in which it resides), then the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that foreign entity. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

On deconsolidation of a subsidiary, the derecognized equity components include any NCI and amounts previously recognized in AOCI (see section 7.6.10). If the subsidiary being derecognized is a foreign entity, AOCI includes the related CTA. [810-10-40-4A]

See chapter 4 of KPMG Handbook, Foreign currency, for additional discussion on accounting for foreign currency when deconsolidating a subsidiary.

Question 7.6.130

How does a parent account for CTA when it sells or liquidates a consolidated foreign entity?

Interpretive response: On a complete or substantially complete liquidation of a foreign entity, a parent recognizes as part of the gain or loss the related CTA in the same period in which the gain or loss on sale or liquidation is recognized. The same guidance applies to a sale of 100% of the foreign subsidiary. [830-30-40-1, 810-10-40-4A]

See section 4 of KPMG Handbook, Foreign currency, for additional discussion, including how 'substantial liquidation' is interpreted.

Question 7.6.140

How does a parent account for CTA in a partial sale of an investment in a consolidated foreign entity?

Interpretive response: The accounting treatment for the CTA is based on whether the parent retains a controlling financial interest in the foreign entity.

Parent retains a controlling financial interest	Parent does not retain a controlling financial interest
The parent accounts for the sale as an equity transaction and no gain or loss is recognized in net income (see Question 7.5.160). No CTA is recognized in net income. [830-30-40-3] In these situations, we believe that a pro rata share of the CTA related to the interest sold should be transferred from the CTA balance related to the foreign subsidiary reported in AOCI to the NCI account at the time of the sale. This treatment is consistent with: — the guidance in Question 7.5.160, and — the accounting under Subtopic 810-10 for allocating AOCI (including translation adjustment) accounts between the parent and NCI.	The parent deconsolidates the foreign entity and recognizes a gain or loss in net income (see Question 7.6.20). The parent's entire CTA balance related to the foreign subsidiary is recognized in net income at the time of sale.

See section 4 of KPMG Handbook, Foreign currency, for additional discussion.

Question 7.6.150

How does a parent account for a sale of a consolidated foreign entity's net assets?

Interpretive response: A parent may enter into a transaction to sell a group of net assets within a consolidated foreign entity while retaining a 100% equity interest in the subsidiary.

If the sale is in the scope of Subtopic 810-10 (Question 7.6.10), the parent derecognizes the group of assets and recognizes a gain or loss on the sale. The parent also applies the guidance in Subtopic 830-30 to determine whether to recognize any related CTA in net income. [810-10-40-4A]

Sale results in the complete or substantially complete liquidation of a foreign entity	Sale does not represent a complete or substantially complete liquidation of a foreign entity
The CTA is recognized in net income (see Question 7.6.130).	No amount of the CTA is recognized in net income (see Question 7.6.140)

In many cases, the disposition of the net asset group does not constitute a substantial liquidation of the foreign subsidiary.

See Question 4.7 and section 4 of KPMG Handbook, Foreign currency, for additional discussion, including how 'substantial liquidation' is interpreted.

7.7 CFEs

7.7.10 Initial measurement

Excerpt from ASC 810-10

20 Glossary

Collateralized Financing Entity - A variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

> Collateralized Financing Entities

15-17D The guidance on **collateralized financing entities** in this Topic provides a measurement alternative to Topic 820 on fair value measurement and applies to a reporting entity that consolidates a collateralized financing entity when both of the following conditions exist:

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

> Collateralized Financing Entities

30-10 When a reporting entity initially consolidates a **variable interest entity** that is a **collateralized financing entity** that meets the scope requirements in paragraph 810-10-15-17D, it may elect to measure the financial assets and the financial liabilities of the collateralized financing entity using a measurement alternative to Topic 820 on fair value measurement.

30-11 Under the measurement alternative, the reporting entity shall measure both the financial assets and the financial liabilities of the collateralized financing entity using the more observable of the fair value of the financial assets and the fair value of the financial liabilities. Any gain or loss that results from the initial application of this measurement alternative shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

30-12 If the fair value of the financial assets of the **collateralized financing entity** is more observable, those financial assets shall be measured at fair value. The financial liabilities shall be measured in the initial consolidation as the difference between the following two amounts:

a. The sum of:
   1. The fair value of the financial assets
   2. The carrying value of any nonfinancial assets held temporarily

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

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

30-13 If the fair value of the financial liabilities of the collateralized financing entity is more observable, those financial liabilities shall be measured at fair value. The financial assets shall be measured in the initial consolidation as the difference between the following two amounts:

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

b. The carrying value of any nonfinancial assets held temporarily.

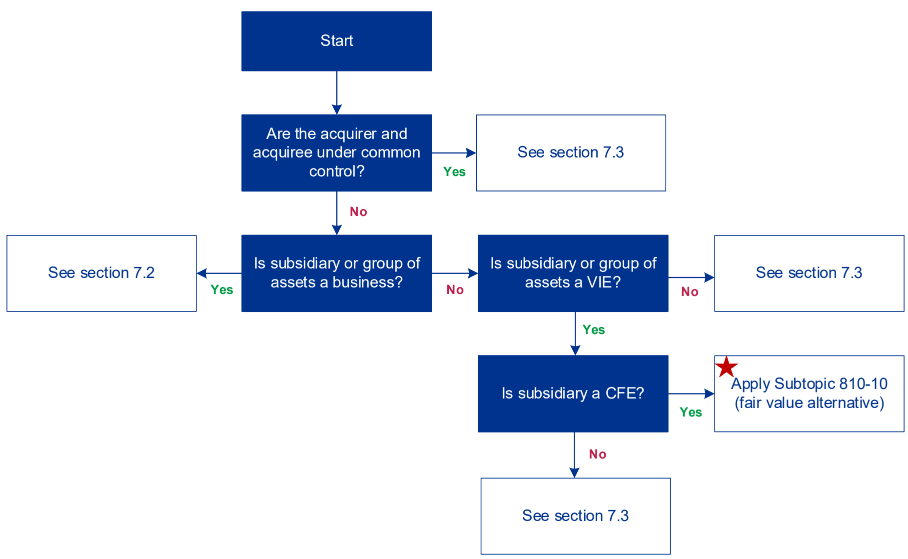
The fair value of the financial liabilities in (a)(1) should include the carrying values of any financial liabilities that are incidental to the operations of the collateralized financing entity because the financial liabilities' carrying values approximate their fair values.

30-14 The amount resulting from paragraph 810-10-30-12 or paragraph 810-10-30-13 shall be allocated to the less observable of the financial assets and financial liabilities (other than the beneficial interests retained by the reporting entity), as applicable, using a reasonable and consistent methodology.

30-15 The carrying value of the beneficial interests that represent compensation for services (for example, rights to receive management fees or servicing fees) and the carrying value of any nonfinancial assets held temporarily by the **collateralized financing entity** shall be measured in accordance with other applicable Topics.

30-16 If a reporting entity does not elect to apply the measurement alternative to a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, the reporting entity shall measure the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity using the requirements of Topic 820 on fair value measurement. If Topic 820 is applied, any initial difference in the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

As discussed in section 7.3, a primary beneficiary that initially consolidates a VIE that is not a business and is not under common control with the primary beneficiary applies the initial recognition guidance in Subtopic 810-10. The initial recognition guidance differs depending on whether the VIE is a CFE to which the measurement alternative is applied, as shown in the following diagram.



A CFE is a VIE that holds financial assets (e.g. as asset-backed securities) and issues beneficial interests to investors. These beneficial interests are usually debt instruments that are considered financial liabilities under US GAAP. A CFE's assets are the sole source of repayment for the beneficial interests (i.e. its liabilities). The beneficial interests are entitled to receive all of the cash flows from the CFE's assets after payment of management fees and other expenses.

Because a CFE generally has little or no equity, it is typically a VIE and subject to the VIE consolidation model. However, a primary beneficiary may elect to measure certain CFEs' financial assets and financial liabilities using the measurement alternative. The measurement alternative allows the primary beneficiary to measure both the financial assets and the financial liabilities of the CFE based on the more observable of the fair value of the assets or the fair value of the liabilities. [810-10-30-10 – 30-11]

If a primary beneficiary elects to not apply the measurement alternative when the CFE is otherwise eligible to do so, it measures the financial assets and financials liabilities at their respective fair values under Topic 820. [810-10-30-16]

Question 7.7.10
What are the requirements to elect the measurement alternative?

Interpretive response: The measurement alternative is available for CFEs that hold only: [810-10-15-17D]

- financial assets and financial liabilities that are measured at fair value through net income;
- assets or liabilities:
  - that are incidental to the financial assets and financial liabilities; and
  - whose carrying amounts approximate fair value – e.g. cash or receivables and payables related to the financial assets and liabilities; and
- nonfinancial assets that are held temporarily as a result of default or an attempt to restructure by the debtor on an underlying debt instrument held as an asset.

A CFE is a VIE that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the CFE and are classified as financial liabilities. A CFE may hold nonfinancial assets temporarily and may also hold other financial assets and financial liabilities that are incidental to its operations and have carrying amounts that approximate fair value (e.g. cash, broker receivables, broker payables). [810-10 Glossary]

Primary beneficiaries elect the measurement alternative at initial consolidation and may do so on an individual CFE-by-CFE basis. [810-10-30-10]

Question 7.7.20
How is the measurement alternative applied at initial consolidation?

Interpretive response: Under the measurement alternative, the primary beneficiary measures the CFE's financial assets and liabilities based on the more observable of either: [810-10-30-10 – 30-11]

- the fair value of the financial assets; or
- the fair value of the financial liabilities.

At initial consolidation, measure the financial assets and financial liabilities as follows.

If the fair value of the financial assets is more observable: [810-10-30-10 – 30-11]		
Measure the financial assets at fair value		
Measure the financial liabilities as the difference between:		
The fair value of the financial assets (excluding those incidental to the CFE's operations) + The carrying amount of any nonfinancial assets held temporarily	AND	The fair value of any beneficial interests retained by the primary beneficiary + The carrying amount of beneficial interests that represent compensation for services
If the fair value of the financial liabilities is more observable: [810-10-30-13]		
Measure the financial liabilities at fair value		
Measure the financial assets as the difference between:		
The fair value of the financial liabilities (other than the beneficial interests retained by the primary beneficiary and those incidental to the CFE's operations) + The fair value of any beneficial interests retained by the primary beneficiary (other than those that represent compensation for services) + The primary beneficiary's carrying amount of any beneficial interests that represent compensation for services	AND	The carrying amount of any nonfinancial assets held temporarily

The resulting amount from these computations is allocated to the less observable of the financial assets and financial liabilities (other than the beneficial interests retained by the primary beneficiary) using a reasonable and consistent methodology. [810-10-30-14]

The following amounts are measured using other US GAAP:

— beneficial interests that represent compensation for services – e.g. rights to receive management fees and servicing fees; and
— nonfinancial assets that are held temporarily.

See Example 7.4.30 (fair value of financial assets more observable) and Example 7.4.40 (fair value of financial liabilities more observable). [810-10-55-205AS – 205AT]

Question 7.7.30

Must a primary beneficiary use the same basis as the more observable fair value for all its consolidated CFEs?

Interpretive response: No. Electing the measurement alternative is made on a CFE-by-CFE basis. Therefore, we believe the determination of the more observable fair value (i.e. the financial assets or the financial liabilities) should also be made on a CFE-by-CFE basis. [810-10-30-16]

Question 7.7.40

When a primary beneficiary does not apply the measurement alternative, how does it initially recognize the CFE's assets and liabilities?

Interpretive response: The primary beneficiary applies the guidance on acquiring a VIE that is not a business in section 7.3 when recognizing and measuring the CFE's assets and liabilities (including its financial assets and financial liabilities) on initial consolidation.

If the measurement alternative is not applied, the CFE's assets and liabilities are generally recognized at their individual fair values under Topic 820. If a gain or loss is recognized at initial consolidation, we believe it should be attributed to the primary beneficiary (see Question 7.3.150). [810-10--30-4]

Question 7.7.50

How are assets transferred to a CFE by the primary beneficiary measured?

Interpretive response: Assets transferred to a CFE by the primary beneficiary continue to be measured using the primary beneficiary's measurement method before the transfer (see Question 7.3.140).

Therefore, the ability to elect the measurement alternative depends on the measurement method applied by the primary beneficiary.

If before transfer…	Then after transfer…
the primary beneficiary measures assets to be transferred at amortized cost or at fair value through OCI,	the CFE does not qualify for the measurement alternative upon initial consolidation.
the primary beneficiary measures assets to be transferred at fair value through net income,	the CFE qualifies for the measurement alternative upon initial consolidation (if all other eligibility requirements are met.

See Question 7.7.10 for the requirements in applying the measurement alternative.

Question 7.7.60

If a primary beneficiary applies the measurement alternative, must the CFE elect the fair value option in its separate financial statements?

Interpretive response: No. The measurement alternative applies only to the CFE's primary beneficiary. [810-10-15-17D]

A CFE is not required to elect the fair value option in its separate financial statements, but it may do so. Further, we believe the measurement alternative election can be made at any level in the chain of parent-subsidiary relationships. For example, a primary beneficiary that consolidates a CFE could elect the measurement alternative in its consolidated financial statements even if its parent elects not to do so.

7.7.20 Subsequent measurement

Excerpt from ASC 810-10

> Collateralized Financing Entities

35-6 A reporting entity that elects to apply the measurement alternative to Topic 820 on fair value measurement upon initial consolidation of a **collateralized financing entity** that meets the scope requirements in paragraph 810-10-15-17D shall consistently apply the measurement alternative for the subsequent measurement of the financial assets and the financial liabilities of that consolidated collateralized financing entity provided that it continues to meet the scope requirements in paragraph 810-10-15-17D. If a collateralized financing entity subsequently fails to meet the scope requirements, a reporting entity shall no longer apply the measurement alternative to that collateralized financing entity. Instead, it shall apply Topic 820 to measure those financial assets and financial liabilities that were previously measured using the measurement alternative.

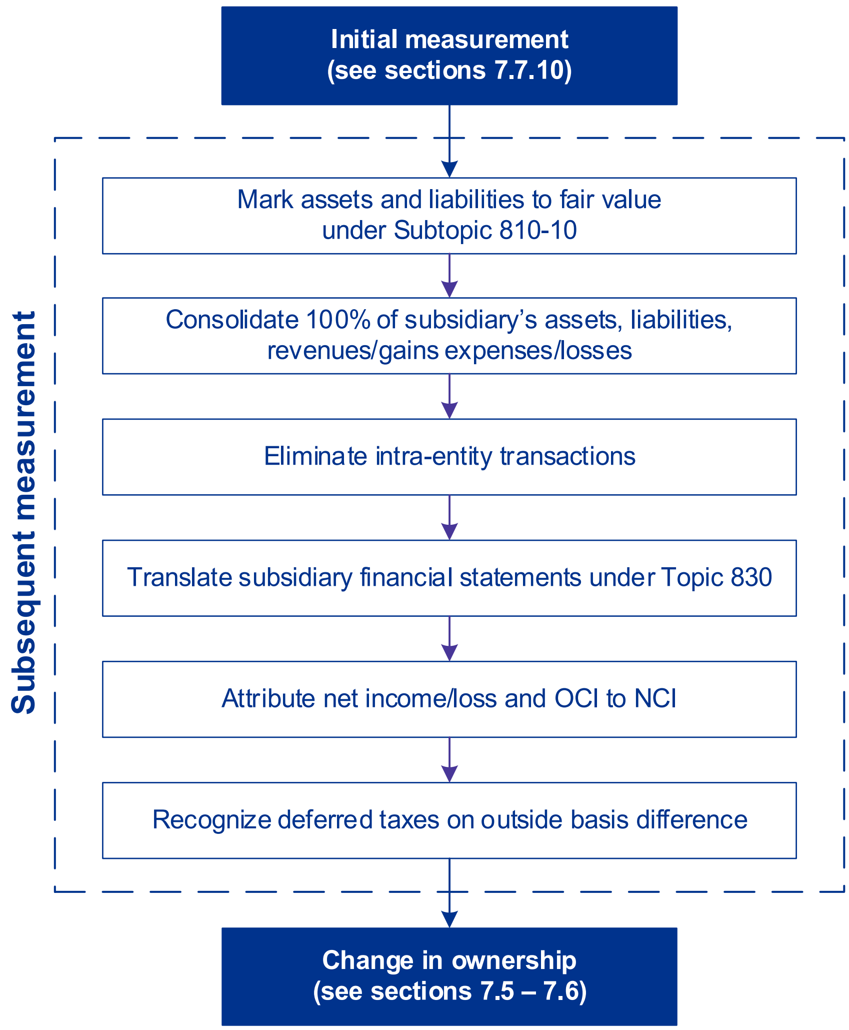
35-7 Under the measurement alternative, a reporting entity shall measure both the financial assets and the financial liabilities of the collateralized financing entity using the more observable of the fair value of the financial assets and the fair value of the financial liabilities, as described in paragraphs 810-10-30-12 through 30-15.

35-8 A reporting entity that applies the measurement alternative shall recognize in its earnings all amounts that reflect its own economic interests in the consolidated **collateralized financing entity**, including both of the following:

a. The changes in the fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)

b. Beneficial interests that represent compensation for services (for example, management fees or servicing fees).

35-9 If a reporting entity does not apply the measurement alternative to a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, the reporting entity shall measure the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity using the requirements of Topic 820 on fair value measurement. If Topic 820 is applied, any subsequent changes in the fair value of the financial assets and the changes in the fair value of the financial liabilities of the collateralized financing entity shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).



The primary beneficiary of a CFE may elect to measure the CFE's financial assets and liabilities using the measurement alternative if certain requirements are met (see section 7.7.10). The measurement alternative allows the primary beneficiary to measure both the financial assets and the financial liabilities of the CFE based on the more observable of the fair value of the assets and the fair value of the liabilities. [810-10-30-10 – 30-11, 35-7]

When a primary beneficiary applies the measurement alternative, it must do so consistently each period. However, if a CFE no longer qualifies for the measurement alternative in a particular reporting period, the primary beneficiary generally measures the CFE's financial assets and financial liabilities at their respective fair values under Topic 820. [810-10-35-6]

Question 7.7.70

What is the impact on subsequent measurement of electing vs not electing the measurement alternative?

Interpretive response: If the primary beneficiary elects the measurement alternative, the changes in the fair values of the CFE's financial assets and financial liabilities that are held by third parties offset in the consolidated financial statements. This is because both are measured based on either the fair value of the financial assets or the fair value of the liabilities, whichever is more observable (see Question 7.7.20). [810-10-35-7]

As a result, the income statement effect of consolidating the CFE equals the changes in: [810-10-35-8, 55-205AS – 55-205AT]

— the fair value of the primary beneficiary's owned beneficial interests in the CFE; and

— the beneficial interests the primary beneficiary has received as compensation for services – measured under other US GAAP (e.g. Topic 606).

If the CFE also temporarily holds nonfinancial assets, those are recognized and measured under other US GAAP – e.g. Topic 360 (property, plant and equipment). [810-10-55-205AS – 55-205AT]

If the primary beneficiary does not elect the measurement alternative, it measures the CFE's financial assets and the financial liabilities at their respective fair values under Topic 820. Those individual fair values likely will not offset. As a result, there will be greater income statement volatility if the primary beneficiary does not apply the measurement alternative. The volatility that is recognized in net income is attributed entirely to the primary beneficiary. [810-10-35-9]

Subtopic 810-10's Example 9 illustrates the application of the measurement alternative when the fair value of the financial assets is more observable. Subtopic 810-10's Example 10 illustrates the application of the measurement alternative when the fair value of the financial liabilities is more observable. Both examples are reproduced directly below.

Excerpt from ASC 810-10

>> Example 9: Collateralized Financing Entities—Application of the Measurement Alternative to the Financial Liabilities When the Fair Value of the Financial Assets Is More Observable

55-205AS A reporting entity has determined that it must consolidate a **collateralized financing entity** under this Topic and is eligible to and has elected to apply the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8. The reporting entity retains certain beneficial interests in the collateralized financing entity as compensation for its services and also retains other **beneficial interests**. Since initial consolidation, the collateralized financing entity has not settled any of the outstanding beneficial interests related to compensation for services. The collateralized financing entity's only assets are corporate debt obligations, and its only liabilities (the beneficial interests issued by the collateralized financing entity) are thinly traded. The reporting entity determines that the fair value of the collateralized financing entity's financial assets is more observable than the fair value of its financial liabilities. Because the fair value of the financial assets is more observable, the reporting entity determines the amount of the financial liabilities of the collateralized financing entity (other than those beneficial interests retained by the reporting entity) as follows.

	June 20, 20X4 (Measurement upon Initial Consolidation)		December 31,20X4	
Fair value of the financial assets[(a)]	$	100	$	105
Plus: Carrying value of the nonfinancial assets[(b)]		5		5
Total value of the assets of the collateralized financing entity		105		110
Less: Fair value of the beneficial interests retained by the reporting entity (other than those that represent compensation for services)[(c)]		10		12
Less: Carrying value of the beneficial interest related to compensation for services[(d)]		6		8
Financial liabilities related to the collateralized financing entity in consolidation		89		90
Net assets related to the collateralized financing entity[(e)]	$	16	$	20
Change in the net assets related to the collateralized financing entity[(f)]			$	4
Changes in the beneficial interests attributable to the reporting entity[(f)]			$	4

(a) The financial assets include $5 and $10 at June 20, 20X4, and December 31, 20X4, respectively, of cash held by the collateralized financing entity. The carrying value of the cash and cash equivalents is equal to the fair value.

(b) To determine the financial liabilities of the collateralized financing entity, the reporting entity uses the sum of the fair value of the financial assets and the carrying value of the nonfinancial assets. The nonfinancial assets of the collateralized financing entity are measured in accordance with other Topics.

(c) This amount represents the fair value of the beneficial interests retained by the reporting entity (other than those that represent compensation for services) determined in accordance with Topic

820. This amount is not included in the financial liabilities of the consolidated reporting entity because it does not represent an amount due to third-party beneficial interest holders.

(d) The reporting entity has rights to a portion of the beneficial interests through its compensation arrangement. That amount is measured in accordance with other Topics. That amount is not included in the financial liabilities of the consolidated reporting entity because it does not represent an amount due to third-party beneficial interest holders.

(e) The net assets related to the collateralized financing entity equal the reporting entity's beneficial interests (that is, the sum of the fair value of the beneficial interests retained [other than those that represent compensation] and the carrying value of beneficial interests that represent compensation for services). The change in the net assets is included in the reporting entity's consolidated net income (loss).

(f) The change in the net assets related to the collateralized financing entity equals the change in the value of the beneficial interests retained by the reporting entity, including the change in the carrying value of the beneficial interests representing compensation for services.

Excerpt from ASC 810-10

>> Example 10: Collateralized Financing Entities—Application of the Measurement Alternative to the Financial Assets When the Fair Value of the Financial Liabilities Is More Observable

55-205AT A reporting entity has determined that it must consolidate a **collateralized financing entity** under this Topic and is eligible to and has elected to apply the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8. The reporting entity retains certain **beneficial interests** in the collateralized financing entity as compensation for its services and also retains other beneficial interests. Since initial consolidation, the collateralized financing entity has not settled any of the outstanding beneficial interests related to compensation for services. The collateralized financing entity's only assets are mortgages with primarily unobservable inputs, and its only liabilities are beneficial interests issued in those assets. The beneficial interests of the collateralized financing entity are frequently traded, although not in an active market. Because the fair value of the financial liabilities is more observable, the reporting entity determines the amount of the financial assets of the collateralized financing entity as follows.

	June 20, 20X4 (Measurement upon Initial Consolidation)	December 31,20X4
Fair value of the financial liabilities (other than beneficial interests retained by the reporting entity)[(a)]	$ 90	$ 95
Plus: Fair value of the beneficial interests retained by the reporting entity (other than those that represent compensation for services)[(b)]	10	12
Plus: Carrying value of the beneficial interests related to compensation for services[(c)]	6	8
Total value of the financial liabilities of the collateralized financing entity[(d)]	106	115
Less: Carrying value of the nonfinancial assets[(e)]	5	5
Financial assets of the collateralized financing entity	101	110

Net assets related to the collateralized financing entity[(f)]	16	20
Change in the net assets related to the collateralized financing entity[(g)]		$ 4
Changes in the beneficial interests attributable to the reporting entity[(g)]		$ 4

(a) This amount reflects the fair value of the beneficial interests held by third parties in the consolidated financial statements. While any beneficial interests retained by the reporting entity are financial liabilities of the collateralized financing entity, such amounts are eliminated in consolidation because they do not represent amounts due to third-party beneficial interest holders. This amount also includes $6 and $8 at June 20, 20X4, and December 31, 20X4, respectively, of payables held by the collateralized financing entity for securities purchased but not yet settled. The carrying amount of those payables approximates fair value.

(b) This amount represents the fair value of the beneficial interests retained by the reporting entity (other than those that represent compensation for services).

(c) The reporting entity holds beneficial interests that represent compensation for services. This amount is measured in accordance with other Topics.

(d) The total liabilities of the collateralized financing entity include the beneficial interests held by third parties, the beneficial interests retained by the reporting entity, and any beneficial interests related to compensation. The reporting entity's beneficial interests (including those related to compensation) are financial liabilities of the collateralized financial entity that are eliminated in consolidation.

(e) The nonfinancial assets of the collateralized financing entity are measured in accordance with other Topics.

(f) The net assets related to the collateralized financing entity equal the reporting entity's beneficial interests (that is the sum of the fair value of the beneficial interests retained [other than those that represent compensation] and the carrying value of beneficial interests that represent compensation for services). The change in the net assets is included in the reporting entity's consolidated net income (loss).

(g) The change in the net assets related to the collateralized financing entity equals the change in the value of the beneficial interests attributable to the reporting entity, including the change in the carrying value of the beneficial interests representing compensation for services.

8. Presentation and disclosure

Detailed contents

Item significantly updated in this edition: #

8.1 How the standard works

The goal of the consolidated financial statements is to present a controlled group as one single economic entity.

Consolidated financial statements	
Foundational principles	— Parent combines its own assets, liabilities and components of comprehensive income with the assets, liabilities and components of comprehensive income of legal entities in which it has a controlling financial interest. — Parent eliminates any intra-entity transactions. — Amounts attributable to NCI in subsidiaries are collapsed into single lines in the income statement and on the balance sheet.
Exceptions	— NCI must be presented in two lines on the balance sheet by entities that are subject to SEC reporting requirements if some are redeemable and have certain characteristics. — A company presents the assets and liabilities of certain VIEs separately on the consolidated balance sheet. — Investors in the construction and extractive industries may proportionately consolidate an investee in the same industry. — Certain investors may proportionately consolidate undivided interests in real property.
Disclosure requirements in Subtopic 810-10	— Consolidation policy. — Scope-related disclosures and use of the accounting alternatives for private companies and collateralized financing entities. — Quantitative information about amounts attributable to, and changes in, NCI. — Deconsolidation of subsidiaries. — Assumptions used in evaluating the consolidation and presentation of VIEs. — Quantitative and qualitative information about investments in VIEs.

8.2 Presentation

8.2.10 Overview

Excerpt from ASC 810-10

10-1 The purpose of **consolidated financial statements** is to present, primarily for the benefit of the **owners** and creditors of the **parent**, the results of operations and the financial position of a parent and all its **subsidiaries** as if the **consolidated group** were a single economic entity. There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities.

> Combined Financial Statements

45-10 If **combined financial statements** are prepared for a group of related entities, such as a group of commonly controlled entities, intra-entity transactions and profits or losses shall be eliminated, and **noncontrolling interests**, foreign operations, different fiscal periods, or income taxes shall be treated in the same manner as in consolidated financial statements.

> Parent-Entity Financial Statements

45-11 In some cases parent-entity financial statements may be needed, in addition to consolidated financial statements, to indicate adequately the position of bondholders and other creditors or preferred shareholders of the parent. Consolidating financial statements, in which one column is used for the parent and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information. However, consolidated financial statements are the general-purpose financial statements of a parent having one or more subsidiaries; thus, parent-entity financial statements are not a valid substitute for consolidated financial statements.

Consolidated financial statements present the results of operations and financial position of a parent and its subsidiaries as a single economic entity. In preparing consolidated financial statements, the parent combines each of its assets, liabilities and components of comprehensive income with those of the legal entities in which it has a controlling financial interest and then eliminates intra-entity transactions (see chapter 7). [810-10-10-1, 45-10]

The consolidated amounts are presented in their natural classifications – except for the assets and liabilities of certain VIEs (see section 8.1.30). The portion of the equity of a subsidiary that is not owned by the parent is NCI (see section 8.1.20).

An entity may also present parent-entity financial statements, which show the results of the parent entity as if its consolidated subsidiaries were unconsolidated investments. However, such statements can be presented only in addition to consolidated financial statements, which present combined amounts as described above. [810-10-45-11]

8.2.20 NCI

Excerpt from ASC 810-10

General

> Noncontrolling Interest in a Subsidiary

>> Nature and Classification of the Noncontrolling Interest in the Consolidated Statement of Financial Position

45-15 The ownership interests in the subsidiary that are held by owners other than the parent is a noncontrolling interest. The noncontrolling interest in a subsidiary is part of the equity of the consolidated group.

45-16 The noncontrolling interest shall be reported in the consolidated statement of financial position within equity (net assets), separately from the parent's equity (or net assets). That amount shall be clearly identified and labeled, for example, as noncontrolling interest in subsidiaries (see paragraph 810-10-55-4I). An entity with noncontrolling interests in more than one subsidiary may present those interests in aggregate in the consolidated financial statements. A **not-for-profit entity** shall report the effects of any donor-imposed restrictions, if any, in accordance with paragraph 958-810-45-1.

45-16A Only either of the following can be a noncontrolling interest in the consolidated financial statements:

a. A financial instrument (or an embedded feature) issued by a subsidiary that is classified as equity in the subsidiary's financial statements
b. A financial instrument (or an embedded feature) issued by a parent or a subsidiary for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary, that is considered indexed to the entity's own stock in the consolidated financial statements of the parent and that is classified as equity.

45-17 A financial instrument issued by a subsidiary that is classified as a liability in the subsidiary's financial statements based on the guidance in other Subtopics is not a noncontrolling interest because it is not an ownership interest. For example, Topic 480 provides guidance for classifying certain financial instruments issued by a subsidiary.

45-17A An equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable GAAP) within the scope of the guidance in paragraph 815-40-15-5C shall be presented as a component of noncontrolling interest in the consolidated financial statements whether the instrument was entered into by the parent or the subsidiary. However, if such an equity-classified instrument was entered into by the parent and expires unexercised, the carrying amount of the instrument shall be reclassified from the noncontrolling interest to the controlling interest.

Excerpt from ASC 480-10

General

> SEC Staff Guidance

>> Staff Accounting Bulletins

>>> SAB Topic 3.C, Redeemable Preferred Stock

S99-2 The following is the text of SAB Topic 3.C, Redeemable Preferred Stock.

Facts: Rule 5-02.27 of Regulation S-X states that redeemable preferred stocks are not to be included in amounts reported as stockholders' equity, and that their redemption amounts are to be shown on the face of the balance sheet. However, the Commission's rules and regulations do not address the carrying amount at which redeemable preferred stock should be reported, or how changes in its carrying amount should be treated in calculations of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends.

Question 1: How should the carrying amount of redeemable preferred stock be determined?

Interpretive Response: The initial carrying amount of redeemable preferred stock should be its fair value at date of issue. Where fair value at date of issue is less than the mandatory redemption amount, the carrying amount shall be increased by periodic accretions, using the interest method, so that the carrying amount will equal the mandatory redemption amount at the mandatory redemption date. The carrying amount shall be further periodically increased by amounts representing dividends not currently declared or paid, but which will be payable under the mandatory redemption features, or for which ultimate payment is not solely within the control of the registrant (e. g., dividends that will be payable out of future earnings). Each type of increase in carrying amount shall be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital.

The accounting described in the preceding paragraph would apply irrespective of whether the redeemable preferred stock may be voluntarily redeemed by the issuer prior to the mandatory redemption date, or whether it may be converted into another class of securities by the holder. Companies also should consider the guidance in FASB ASC paragraph 480-10-S99-3A (Distinguishing Liabilities from Equity Topic).

Question 2: How should periodic increases in the carrying amount of redeemable preferred stock be treated in calculations of earnings per share and ratios of earnings to combined fixed charges and preferred stock dividends?

Interpretive Response: Each type of increase in carrying amount described in the Interpretive Response to Question 1 should be treated in the same manner as dividends on nonredeemable preferred stock.

>> Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings

>>> SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

Background

1. This SEC staff announcement provides the SEC staff's views regarding the application of Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks."*[FN1]

   FN1 ASR 268 (SEC Financial Reporting Codification, Section No. 211, *Redeemable Preferred Stocks*) is incorporated into SEC Regulation S-X, Articles 5-02.27, 7-03.21, and 9-03.19. Hereafter, reference is made only to ASR 268.

Scope

2. ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. As noted in ASR 268, the Commission reasoned that "[t]here is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital."
3. Although ASR 268 specifically describes and discusses preferred securities, the SEC staff believes that ASR 268 also provides analogous guidance for other redeemable equity instruments including, for example, common stock, derivative instruments, noncontrolling interests [FN2], securities held by an employee stock ownership plan [FN3], and share-based payment arrangements with employees [FN4]. The SEC staff's views regarding the applicability of ASR 268 in certain situations is described below.

   FN2 The Master Glossary defines ***noncontrolling interest*** as "The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest." ASR 268 applies to redeemable noncontrolling interests (provided the redemption feature is not considered a freestanding option within the scope of Subtopic 480-10). Where relevant, specific classification and measurement guidance pertaining to redeemable noncontrolling interests has been included in this SEC staff announcement.

   FN3 ASR 268 applies to equity securities held by an employee stock ownership plan (whether or not allocated) that, by their terms, can be put to the registrant (sponsor) for cash or other assets. Where relevant, specific classification and measurement guidance pertaining to employee stock ownership plans has been included in this SEC staff announcement.

FN4 As indicated in Section 718-10-S99, ASR 268 applies to redeemable equity-classified instruments granted in conjunction with share-based payment arrangements with employees. Where relevant, specific classification and measurement guidance pertaining to share-based payment arrangements with employees has been included in this SEC staff announcement.

a. *Freestanding financial instruments classified as assets or liabilities.* Freestanding financial instruments that are classified as assets or liabilities pursuant to Subtopic 480-10 or other applicable GAAP (including those that contain separated derivative assets or derivative liabilities) are not subject to ASR 268. [FN5] Mandatorily redeemable equity instruments for which the relevant portions Subtopic 480-10 have been deferred are subject to ASR 268.

FN5 An equity instrument subject to potential redemption under a freestanding written put option is not subject to ASR 268 (since the put option liability is considered a separate unit of account). However, as discussed in paragraph 3(b), when an embedded written put option has been separated from a hybrid financial instrument with an equity host contract, the host equity instrument is subject to ASR 268.

b. *Freestanding derivative instruments classified in stockholders' equity.* Freestanding derivative instruments that are classified in stockholders' equity pursuant to Subtopic 815-40 are not subject to ASR 268. [FN6] Equity-classified freestanding financial instruments that were previously classified outside of permanent equity under Subtopic 815-40 are now classified as assets or liabilities pursuant to Subtopic 480-10. However, Subtopic 815-40 continues to apply to embedded derivatives indexed to, and potentially settled in, a company's own stock. Accordingly, when a hybrid financial instrument that is not classified in its entirety as an asset or liability under Subtopic 480-10 or other applicable GAAP contains an embedded derivative within the scope of Subtopic 815-40, the registrant should consider the applicability of ASR 268 to:
   - The hybrid financial instrument when the embedded derivative is not separated under Subtopic 815-15, or
   - The host contract when the embedded derivative is separated under Subtopic 815-15.

FN6 A freestanding derivative instrument would not meet the conditions in Subtopic 815-40 to be classified as an equity instrument if it was subject to redemption for cash or other assets on a specified date or upon the occurrence of an event that is not within the control of the issuer.

c. *Equity instruments subject to registration payment arrangements.* The determination of whether an equity instrument subject to a registration payment arrangement (as defined in Paragraph 825-20-15-3) is subject to ASR 268 should be made without regard to the existence of the registration payment arrangement (that is, the registration payment arrangement is a separate unit of account). However, in determining the applicability of ASR 268 to an equity instrument with any other related arrangement, a conclusion that the related arrangement is a separate unit of account should not be based on an analogy to Paragraph 815-10-25-16.

d. *Share-based payment awards.* Equity-classified share-based payment arrangements with employees are not subject to ASR 268 due solely to either of the following:
   - Net cash settlement would be assumed pursuant to Paragraphs 815-40-25-11 through 25-16 solely because of an obligation to deliver registered shares. [FN7]
   - A provision in an instrument for the direct or indirect repurchase of shares issued to an employee exists solely to satisfy the employer's minimum statutory tax withholding requirements (as discussed in Paragraphs 718-10-25-18 through 25-19).

   FN7 See footnote 84 of Section 718-10-S99.

e. *Convertible debt instruments that contain a separately classified equity component.* Other applicable GAAP may require a convertible debt instrument to be separated into a liability component and an equity component. [FN8] In these situations, the equity-classified component of the convertible debt instrument should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash or other assets (that is, the instrument is currently redeemable or convertible for cash or other assets). For these instruments, an assessment of whether the convertible debt instrument will become redeemable or convertible for cash or other assets at a future date should not be made. For example, a convertible debt instrument that is not redeemable at the balance sheet date but could become redeemable by the holder of the instrument in the future based on the passage of time or upon the occurrence of a contingent event is not considered currently redeemable at the balance sheet date.

   FN8 See Subtopics 470-20 and 470-50; and Paragraph 815-15-35-4.

f. *Certain redemptions upon liquidation events.* Ordinary liquidation events, which involve the redemption and liquidation of all of an entity's equity instruments for cash or other assets of the entity, do not result in an equity instrument being subject to ASR 268. In other words, if the payment of cash or other assets is required only from the distribution of net assets upon the final liquidation or termination of an entity (which may be a less-than-wholly-owned consolidated subsidiary), then that potential event need not be considered when applying ASR 268. Other transactions are considered deemed liquidation events. For example, the contractual provisions of an equity instrument may require its redemption by the issuer upon the occurrence of a change-in-control that does not result in the liquidation or termination of the issuing entity, a delisting of the issuer's securities from an exchange, or the violation of a debt covenant. Deemed liquidation events that require (or permit at the holder's option) the redemption of only one or more particular class of equity instrument for cash or other assets cause those instruments to be subject to ASR 268. However, as a limited exception, a deemed liquidation event does not cause a particular class of equity instrument to be classified outside of permanent equity if all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem).

g. *Certain redemptions covered by insurance proceeds.* As a limited exception that should not be analogized to, an equity instrument that becomes redeemable upon the death of the holder (at the option of the holder's heir or estate [FN9]) or upon the disability of the holder is not subject to ASR 268 if the redemption amount will be funded from the proceeds of an insurance policy that is currently in force and which the registrant has the intent and ability to maintain in force.

FN9 If an equity instrument is required to be redeemed for cash or other assets upon the death of the holder, the instrument is classified as a liability pursuant to Subtopic 480-10 even if an insurance policy would fund the redemption.

Classification

4. ASR 268 requires equity instruments with redemption features that are not solely within the control of the issuer to be classified outside of permanent equity (often referred to as classification in "temporary equity"). The SEC staff does not believe it is appropriate to classify a financial instrument (or host contract) that meets the conditions for temporary equity classification under ASR 268 as a liability. [FN10]

FN10 At the June 14, 2007 EITF meeting, the SEC Observer stated that a financial instrument (or host contract) that otherwise meets the conditions for temporary equity classification may continue to be classified as a liability provided the financial instrument (or host contract) was classified and accounted for as a liability in fiscal quarters beginning before September 15, 2007 and has not subsequently been modified or subject to a remeasurement (new basis) event.

5. Determining whether an equity instrument is redeemable at the option of the holder or upon the occurrence of an event that is solely within the control of the issuer can be complex. The SEC staff believes that all of the individual facts and circumstances surrounding events that could trigger redemption should be evaluated separately and that the possibility that any triggering event that is not solely within the control of the issuer could occur—without regard to probability—would require the instrument to be classified in temporary equity. Paragraphs 6–11 provide examples of the application of ASR 268.

Examples in which temporary equity classification is appropriate

6. *Example 1.* A preferred security that is not required to be classified as a liability under other applicable GAAP may be redeemable at the option of the holder or upon the occurrence of an event that is not solely within the control of the issuer. Upon redemption (in other than a liquidation event that meets the exception in paragraph 3(f)), the issuer may have the choice to settle the redemption amount in cash or by delivery of a variable number of its own common shares with an equivalent value. For this instrument, the guidance in Section 815-40-25 should be used to evaluate whether the issuer controls the actions or events necessary to issue the maximum number of common shares that could be required to be delivered under share settlement of the contract. If the issuer does not control settlement by delivery of its own common shares (because, for example, there is no cap on the maximum number of common shares that could be potentially issuable upon redemption), cash settlement of the instrument would be presumed and the instrument would be classified as temporary equity.
7. *Example 2.* A preferred security that is not required to be classified as a liability under other applicable GAAP may have a redemption provision that states it may be called by the issuer upon an affirmative vote by the majority of its board of directors. While some might view the decision to call the security as an event that is within the control of the company because the governance structure of the company is vested with the power to avoid redemption, if the preferred security holders control a majority of the votes of the board of directors through direct representation on the board of directors or through other rights, the preferred security is redeemable at the option of the holder and classification in temporary equity is required. In other words, any provision that requires approval by the board of directors cannot be assumed to be within the control of the issuer. All of the relevant facts and circumstances should be considered.
8. *Example 3.* A preferred security that is not required to be classified as a liability under other applicable GAAP may contain a deemed liquidation clause that provides that the security becomes redeemable if the common stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, common stock representing less than a majority of the voting power of the outstanding common stock of the surviving corporation. This change-in-control provision would require the preferred security to be classified in temporary equity if a purchaser could acquire a majority of the voting power of the outstanding common stock without company approval, thereby triggering redemption.
9. *Example 4.* An equity instrument may contain provisions that allow the holder to redeem the instrument for cash or other assets upon the occurrence of events that are not solely within the issuer's control. Such events may include:
   - The failure to have a registration statement declared effective by the SEC by a designated date
   - The failure to maintain compliance with debt covenants
   - The failure to achieve specified earnings targets
   - A reduction in the issuer's credit rating.

Since these events are not solely within the control of the issuer, the equity instrument is required to be classified in temporary equity.

Examples in which permanent equity classification is appropriate

10. *Example 5.* A preferred security may have a provision that the decision by the issuing company to sell all or substantially all of a company's assets and a subsequent distribution to common stockholders triggers redemption of the security. In this case, the security would be appropriately classified in permanent equity if the preferred stockholders cannot trigger or otherwise require the sale of the assets through representation on the board of directors, or through other rights, because the decision to sell all or substantially all of the issuer's assets and the distribution to common stockholders is solely within the issuer's control. In other words, if there could not be a "hostile" asset sale whereby all or substantially all of the issuer's assets are sold, and a dividend or other distribution is declared on the issuer's common stock, without the issuer's approval, then classifying the security in permanent equity would be appropriate.
11. *Example 6.* A preferred security may have a provision that provides for redemption in cash or other assets if the issuing company is merged with or consolidated into another company, and pursuant to state law, approval of the board of directors is required before any merger or consolidation can occur. In that case, assuming the preferred stockholders cannot control the vote of the board of directors through direct representation or through other rights, the security would be appropriately classified in permanent equity because the decision to merge with or consolidate into another company is within the control of the issuer. Again, all of the relevant facts and circumstances should be considered when determining whether the preferred stockholders can control the vote of the board of directors.

Reclassification into Permanent Equity

18. If classification of an equity instrument as temporary equity is no longer required (if, for example, a redemption feature lapses, or there is a modification of the terms of the instrument), the existing carrying amount of the equity instrument should be reclassified to permanent equity at the date of the event that caused the reclassification. Prior financial statements are not adjusted. Additionally, the SEC staff believes that it would be inappropriate to reverse any adjustments previously recorded to the carrying amount of the equity instrument (pursuant to paragraphs 14–16) in conjunction with such reclassifications.

Amounts attributable to the NCI are generally presented on single lines in the income statement (under consolidated net income) and the balance sheet (in the equity section).

However, certain NCI (referred to as 'redeemable NCI') must be presented outside of permanent equity, by entities that are subject to SEC reporting requirements. 'Temporary equity' presentation is generally required if the NCI holder(s) can redeem its interest for a fixed or determinable amount of cash or other assets.

In some cases, NCI is accounted for as a liability (see section 7.2.40). Liability-classified NCI is outside the scope of Topic 810 and is accounted for under Topic 480.

Question 8.2.10

When is NCI presented as 'temporary equity'?

Interpretive response: Registrants present in temporary equity equity-classified preferred ownership interests that are redeemable for cash (or other assets of the issuer) if they are redeemable: [S-X Rule 5-02.27, 480-10-S99-1]

- at a fixed or determinable price on a fixed or determinable date;
- at the option of the holder; or
- upon the occurrence of an event that is not solely in the control of the issuer.

The SEC staff believes this guidance also applies to other redeemable equity instruments, which includes NCI (referred to as 'redeemable NCI'). [480-10-S99-3A]

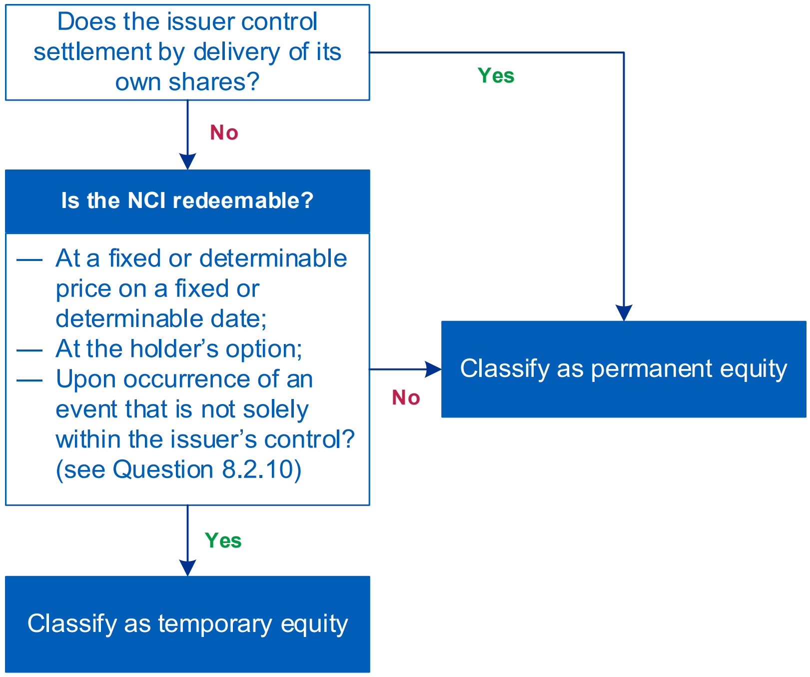
Temporary equity is presented on the balance sheet in the mezzanine between an entity's liabilities and equity. If an instrument is accounted for as a liability under Topic 480 or other applicable US GAAP, it must be presented as a liability – i.e. temporary equity presentation is limited to those instruments defined as such under S-X Rule 5-02.27 (see Question 7.2.120).

We believe a parent that is not subject to SEC reporting requirements may elect an accounting policy to apply the SEC's guidance on redeemable instruments (see Question 8.2.60).

Question 8.2.20

Is NCI presented in temporary equity if the issuer can satisfy the redemption through delivery of its own shares?

Interpretive response: It depends. The parent applies the following decision tree to determine how to classify NCI with redemption features.



Topic 815 (derivatives and hedging) provides guidance on how to evaluate whether an entity controls settlement by delivery of its own shares (see Question 8.2.30). [480-10-S99-3A.6]

Question 8.2.30

When does a parent control settlement of redeemable NCI by delivering its own shares?

Interpretive response: A parent controls share settlement of a redeemable NCI only if all of the following conditions are present. [480-10-S99-3A.6, 815-40-25-7 – 25-35]

- the contract permits settlement in unregistered shares;
- the parent has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of shares during the maximum period the contract could remain outstanding;
- the contract explicitly limits the number of shares required to be delivered in a share settlement;
- there are no required cash payments to the NCI holder(s) in the event the parent fails to make timely filings with the SEC;
- there is no requirement to make cash payments to the NCI holder(s) if the shares initially delivered upon settlement are subsequently sold by the NCI holder(s) and the sales proceeds are insufficient to provide the NCI holder(s) with a full return of the amount due – i.e. there are no potential cash payments required under 'top-off' or 'make-whole provisions';

— the contract requires net-cash settlement only in specific circumstances in which other NCI holder(s) also would receive cash in exchange for their shares;

— no provisions of the contract indicate that the NCI holder(s) has rights that rank higher than those of a shareholder; and

— there is no requirement in the contract to post collateral at any point or for any reason.

The specific terms of the NCI holder(s)' redemption/exchange rights often vary between entities. Therefore, all of the above conditions should be carefully considered when evaluating the presentation of NCI with redemption features.

Question 8.2.35

Does the parent control settlement in shares if its board decides on cash or share settlement?

Interpretive response: It depends. If the board decides whether the redemption is in cash or shares, the parent controls settlement unless the NCI holder(s) controls the board.

To determine whether the NCI holder(s) controls the board, the parent evaluates each class of NCI holder(s), considering whether any of the classes control the board, as well as which parties have the ability to appoint board members.

While a board member may meet the definition of an independent director for one or more other purposes, that member may be considered under the control of the NCI holder(s) depending on the facts and circumstances. Based on discussions with the SEC staff, we believe the NCI holder(s) may control an otherwise independent director if it:

— nominated the director to the board; and
— controls the removal or replacement of the director.

We understand this scenario may arise in the context of evaluating the classification of NCI in an umbrella partnership C Corporation (Up-C) structure. For additional discussion, see Question 7.3.210 and Example 7.3.60 in KPMG Handbook, Debt and equity financing.

Question 8.2.40

Does a redemption feature that provides for delivery of registered shares make the NCI temporary equity?

Interpretive response: It depends. Generally, a parent is unable to control the events or actions necessary to deliver registered shares. If the NCI can be share-settled only by delivering registered shares, it is presumed that the parent will need to settle the redemption in cash. In that situation, the parent presents the redeemable NCI in temporary equity if the redemption terms have any one of the characteristics in S-X Rule 5-02.27 (see Question 8.2.10).

However, we believe the presumption of cash settlement can be overcome if:

- the shares necessary to settle the redemption are already registered when the redeemable NCI is issued; and
- the parent has no further timely filing or registration requirements.

If these conditions are met, we believe a requirement to deliver registered shares does not preclude the parent from asserting that it controls share-settlement of the NCI. In that case, the parent presents the NCI in permanent equity.

Question 8.2.50

Do limits on beneficial ownership affect a parent's control over share settlement?

Interpretive response: Yes. If regulatory or other contractual requirements limit a parent's ability to settle redemption in shares, the parent is generally unable to control share settlement.

For example, regulatory requirements limit the percentage ownership of individual shareholders of a REIT. As a result, if settling the redemption feature in REIT shares would jeopardize a parent's REIT status, it is presumed that the parent will need to settle the redemption in cash. In that case, the parent presents the redeemable NCI in temporary equity if the redemption terms have any one of the characteristics in S-X Rule 5-02.27 (see Question 8.2.10).

Question 8.2.60

Must a parent apply the guidance on temporary equity presentation if it is not subject to SEC reporting?

Interpretive response: No. A parent is required to present redeemable instruments as temporary equity only if it is subject to SEC reporting requirements.

However, we believe a parent that is not subject to SEC reporting requirements may elect an accounting policy to apply the SEC's guidance on redeemable instruments. A parent that elects this policy must apply it consistently to all redeemable instruments. [250-10-45-1 – 45-4]

Further, we believe electing to apply the guidance on temporary equity presentation for redeemable equity interests is preferable to presenting all such instruments as permanent equity.

Question 8.2.70

Does a parent reclassify from temporary to permanent equity redeemable NCI if it is no longer redeemable for cash?

Interpretive response: Yes. As of the date the NCI no longer meets the conditions to be presented as temporary equity (see Question 8.2.10), the parent reclassifies its carrying amount to permanent equity. [480-10-S99-3A.18]

The parent does not: [480-10-S99-3A.18]

- adjust the presentation of the NCI in its prior-period financial statements; or
- reverse any changes to the NCI's carrying amount that were recognized as a result of the redemption feature (see section 7.5.20).

Question 8.2.80

How does a parent classify nonredeemable preferential preferred stock held by NCI holder(s)?

Background: Unlike common stock, nonredeemable preferred stock is generally entitled to a liquidation preference consisting of the par amount and/or cumulative unpaid dividends.

Interpretive response: Any equity-classified ownership interest in the subsidiary that is held by owners other than the parent is classified in consolidated equity as NCI. However, we believe a parent should separately present in consolidated equity any NCI in the form of stock that has a liquidation preference. This presentation is consistent with the separate presentation of such instruments that are issued by the parent. [810-10-45-15 – 45-16A]

Question 8.2.90

How does a parent present in its statement of changes of equity changes in NCI when the NCI is temporary equity?

Background: A parent is required to reconcile total equity at the beginning of the period to total equity at the end of the period. [810-10-50-1A, S-X Rule 3-04]

However, redeemable NCI cannot be included in a total or subtotal that includes: [480-10-S99-1.01, S-X Rule 5-02.27(d)]

- the nonredeemable equity of the parent company shareholders; and/or
- nonredeemable NCI.

Interpretive response: At the June 2009 Center for Audit Quality SEC Regulations Committee Meeting, the SEC staff identified the following two potentially acceptable presentations to satisfy the total equity reconciliation requirements when the parent has redeemable NCI. [SEC Regs Comm 06/09]

Option 1: Include in equity reconciliation

Provide a column for redeemable NCI in the equity reconciliation but exclude the related amounts from the total equity column. In that case, the reconciliation may include a row for net income or a supplemental table identifying the allocation of net income and OCI among controlling interests, nonredeemable NCI and redeemable NCI (see Example 8.2.10).

Option 2: Exclude from equity reconciliation

Exclude redeemable NCI from the equity reconciliation but provide a note or supplemental table reconciling the beginning and ending balance of redeemable NCI. The supplemental table may be provided in the notes to the financial statements or in the statement itself. If the latter, the *net income* caption in the equity reconciliation parenthetically indicates the amounts related to redeemable NCI (see Example 8.2.20).

Example 8.2.10

Redeemable NCI included in consolidated statement of changes in equity (Option 1)

The following table illustrates an equity reconciliation in which redeemable NCI is included.

					ABC shareholders				
	Net income	**Redeem-able NCI**	**Total**	**Compre-hensive income**	**Retained earnings**	**AOCI**	**Common stock**	**Paid-in capital**	**Nonredeem-able NCI**
Beginning		$ 24.0	$410.0	$ -	$140.0	$10.0	$150.0	$60.0	$ 50.0
Adjustment of redeemable equity to redemption value		1.0	(1.0)		(1.0)				
Purchase of sub shares from NCI			(28.0)			2.0		(10.0)	(20.0)
Net income	$42.0	1.0	41.0	41.0	40.0				1.0
OCI		1.0	6.0	6.0		5.0			1.0
Common stock dividends			(20.0)		(20.0)				
Ending		**$ 27.0**	**$408.0**	**$ 47.0**	**$159.0**	**$17.0**	**$150.0**	**$50.0**	**$ 32.0**

ABC may provide the following table in place of the 'Net income' column in the statement above.

Allocation of net income	
Net income attributable to redeemable NCI	$1.0
Net income attributable to nonredeemable NCI	1.0
Net income attributable to controlling interests	40.0
Net income	**$42.0**

Example 8.2.20
Redeemable NCI excluded from consolidated statement of changes in equity (Option 2)

The following table illustrates an equity reconciliation in which redeemable NCI is excluded.

			ABC shareholders				
	Total	**Compre-hensive income**	**Retained earnings**	**AOCI**	**Common stock**	**Paid-In capital**	**Nonredeem-able NCI**
Beginning	$410.0	$-	$140.0	$10.0	$150.0	$60.0	$50.0
Adjustment of redeemable equity to redemption value	(1.0)		(1.0)				
Purchase of sub shares from NCI	(28.0)			2.0		(10.0)	(20.0)
Net income[1]	41.0	41.0	40.0				1.0
OCI	6.0	6.0		5.0			1.0
Common stock dividends	(20.0)		(20.0)				
Ending	**$408.0**	**$47.0**	**$159.0**	**$17.0**	**$150.0**	**$50.0**	**$32.0**

[1] Excludes $1.0 attributable to redeemable NCI.

Note: Beginning redeemable NCI of $24.0 + Net income attributable to redeemable NCI of $1.0 + Adjustment to redemption value of $1.0 + allocation of OCI of $1.0 = Ending redeemable NCI of $27.0.

ABC may provide the following table in place of the 'Note' in the statement above.

Redeemable noncontrolling interests	
Beginning balance	$24.0
Adjustment of redeemable equity to redemption value	1.0
Net income	1.0
OCI	1.0
Ending balance	**$27.0**

Question 8.2.100
Must a subsidiary also use temporary equity classification for its redeemable equity in its separate financial statements?

Interpretive response: Not necessarily. A subsidiary is required to present cash-redeemable instruments as temporary equity in its separate financial statements only if it is subject to SEC reporting requirements. However, even if the subsidiary presents such instruments as permanent equity, we believe it should apply the same measurement principles used in the consolidated financial statements (see section 7.5.20).

Although it is not required to, we believe a subsidiary that is not subject to SEC reporting requirements may elect an accounting policy to apply the presentation guidance on redeemable equity instruments (see Question 8.2.60).

Question 8.2.110

How are transactions with NCI holder(s) presented in the statement of cash flows?

Interpretive response: We believe cash flows for purchase or sale transactions with NCI holder(s) are financing cash flows if the parent retains control and investing cash flows if the parent does not.

Sections 19.4 to 19.6 of KPMG Handbook, Statement of cash flows, provide additional guidance on these transactions and how to classify cash flows for:

- transaction costs incurred when purchasing or selling NCI while retaining control; and
- dividends paid to NCI holder(s).

Question 8.2.120

How do amounts attributable to NCI holder(s) affect consolidated EPS?

Interpretive response: When determining EPS for consolidated financial statements, the numerator is the income (loss) that is available to common shareholders of the parent entity. This 'income (loss) refers to the income (loss) of the consolidated entity after adjusting for the share of income (loss) attributable to NCI.

Section 3.3 of KPMG Handbook, Earnings per share, provides guidance on how:

- to compute consolidated EPS when there is NCI;
- instruments presented in temporary equity affect EPS;
- preferred NCI (including when it is redeemable) affects consolidated EPS; and
- profit-sharing arrangements and guarantees between the parent and NCI holder(s) affect consolidated EPS.

Section 5.3 of the Handbook provides guidance on how income is adjusted for common equity instruments presented in temporary equity when they are redeemable at an amount other than fair value.

Section 6.19 of the Handbook provides guidance on how redeemable shares held by an employee stock ownership plan that are presented as temporary equity affect consolidated EPS.

Question 8.2.125

How is an equity-linked instrument presented if its payoff is based on the stock of a consolidated subsidiary?

Background: A parent entity or its consolidated subsidiary may enter into an equity-linked financial instrument for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary. Examples of such instruments that are freestanding include written or purchased call options (and warrants) on the stock of the consolidated subsidiary. Examples of such instruments that are embedded include convertible debt that is convertible into the stock of the subsidiary. See section 8.2.30 in KPMG Handbook, Debt and equity financing, for additional discussion.

Interpretive response: An equity-linked instrument is presented as a component of NCI in the consolidated financial statements if: [815-40-15-5C]

— the subsidiary is a substantive entity, and

— the financial instrument meets the requirements for equity classification in Topic 815 (if the instrument is freestanding or is embedded but requires separate accounting) or Topic 480 (if the instrument is a hybrid contract from which the equity-linked feature is not bifurcated).

This presentation is required regardless of whether the instrument was entered into by the parent or the subsidiary. However, if the instrument expires unexercised, the carrying amount of the instrument is reclassified from NCI to controlling interest. [810-10-45-17A]

See additional discussion in Question 8.2.90 and Example 8.2.10 in KPMG Handbook, Debt and equity financing.

Question 8.2.130

How do potential common shares in or issued by a subsidiary affect consolidated EPS?

Interpretive response: Potential common shares in or issued by a subsidiary present specific challenges in determining the EPS amounts for the parent's financial statements. Generally, potential common shares of a subsidiary affect only the diluted EPS of the parent.

Section 6.17 of KPMG Handbook, Earnings per share, provides additional guidance on the EPS implications of instruments (e.g. convertible equity instruments, options, warrants) issued to parties outside the consolidated group that are convertible into either common shares of a subsidiary or common shares of the parent.

That section includes guidance on:

— the general effects of those instruments on consolidated basic and diluted EPS;

— the dilutive or antidilutive effect of subsidiary instruments that entitle the holders to common shares of the subsidiary or the parent;
— how subsidiary share-based payment awards affect EPS; and
— how diluted EPS is affected when parent options will be exchanged for subsidiary options in connection with a spinoff or carve-out.

In addition, section 3 of KPMG Handbook, Share-based payment, discusses subsidiary share-based payment awards and the interaction between Topic 810 and Topic 718.

8.2.30 VIEs

Excerpt from ASC 810-10

Variable Interest Entities

45-25 A reporting entity shall present each of the following separately on the face of the statement of financial position:

a. Assets of a consolidated **variable interest entity** (VIE) that can be used to settle obligations of the consolidated VIE
b. Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

As discussed in section 8.2.10, in preparing consolidated financial statements, the parent generally presents 100% of the consolidated assets and liabilities in their natural classifications when preparing the basic financial statements. However, there is an exception for primary beneficiaries of VIEs when certain conditions are met.

Question 8.2.140
When does a primary beneficiary separately present a consolidated VIE's assets and liabilities?

Interpretive response: A primary beneficiary must separately present on the face of the balance sheet: [810-10-45-25]

— assets of a consolidated VIE that can be used only to settle obligations of the VIE; and

— liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

Each of the VIE's assets and liabilities are presented on a gross basis unless other applicable US GAAP allows for net presentation.

Question 8.2.150

Can a primary beneficiary present one line for the VIE's total assets and one line for its total liabilities, or one VIE net asset line?

Interpretive response: No. If a primary beneficiary must separately present a consolidated VIE's assets and liabilities, we believe it identifies the VIE's amounts by their natural classifications – e.g. VIE receivables, VIE investments, VIE property, plant and equipment, VIE accounts payable, VIE notes payable, etc.

We believe the individual captions may be presented as separate line items on the balance sheet or displayed parenthetically on the balance sheet line item in which they are included. In limited circumstances, they may be disclosed in the notes to the financial statements (see Question 8.2.200).

Assets and liabilities of consolidated VIEs that do not require separate presentation are presented on a consolidated basis in their natural classifications – e.g. receivables, investments, property, plant and equipment, accounts payable, notes payable, etc. (see Question 8.2.160).

Example 8.2.30

Balance sheet presentation of VIE assets and liabilities

Parent consolidates VIE and must separately present VIE's assets and liabilities on the consolidated balance sheet.

Parent's accounts receivable balances as of December 31, Year 2 and Year 1 are as follows.

Accounts receivable		
December 31,	**Year 2**	**Year 1**
Parent and subsidiaries, excluding VIE	500	500
VIE	500	400
Total	**1,000**	**900**

Parent has two options for presenting its accounts receivable balance in its consolidated balance sheet.

Option 1		
	Year 2	**Year 1**
Accounts receivable	500	500
Accounts receivable held by VIE	500	400

Option 2		
	Year 2	**Year 1**
Accounts receivable (includes VIE balance of $500 and $400, respectively)	1,000	900

Question 8.2.160

Can a primary beneficiary aggregate the assets and liabilities of multiple consolidated VIEs under the separate presentation requirements?

Interpretive response: Yes. When separately presenting the assets and liabilities of consolidated VIEs, we believe a primary beneficiary may aggregate all VIE balances within one line item classification.

For example, if a primary beneficiary has three VIEs with accounts receivable, it can add all three accounts receivable balances together for separate presentation as discussed in Question 8.2.150.

Question 8.2.170

How does a primary beneficiary present a consolidated VIE's assets and liabilities that do not require separate presentation?

Interpretive response: Assets and liabilities of consolidated VIEs that do not require separate presentation are presented on a consolidated basis in their natural classifications – e.g. receivables, investments, property, plant and equipment, accounts payable, notes payable, etc.

See Question 8.2.140 for guidance on when a VIE's assets and liabilities must be presented separately.

Question 8.2.180

Can a primary beneficiary separately present the assets and liabilities of a consolidated VIE even if not required to do so?

Interpretive response: Yes. We believe a primary beneficiary may make an accounting policy election to separately present a consolidated VIE's assets and liabilities. However, the primary beneficiary should clearly distinguish between VIE assets and liabilities that are required to be separately presented and those that are not. [810-10-45-25]

A primary beneficiary that elects this policy must apply it consistently to the assets and liabilities of all consolidated VIEs. [250-10-45-1 – 45-4]

Question 8.2.190

Does a primary beneficiary separately present VIE assets and liabilities before intra-entity eliminations?

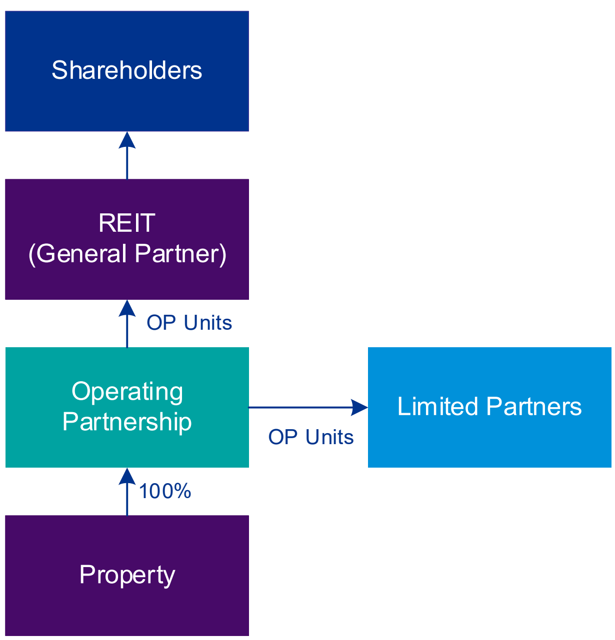
Interpretive response: No. A primary beneficiary separately presents a consolidated VIE's assets and liabilities after it eliminates intra-entity balances and transactions with the VIE (e.g. investments in, and loans extended to, the VIE). [810-10-45-1]

Question 8.2.200

Can an UPREIT disclose the assets and liabilities of its operating partnership in the notes instead of on the balance sheet?

Background: In a typical UPREIT (umbrella partnership real estate investment trust) structure, the REIT is the sole GP of an operating partnership (OP). The REIT generally also holds a large majority of the LP interests of the OP. In this structure, the REIT typically has little or no assets, liabilities or operations other than its interest in the OP.

The following diagram illustrates a typical structure.



In an UPREIT structure, the LPs in the OP (excluding those held by the GP and its related parties) typically lack substantive kick-out rights or participating rights (see section 4.4). As a result, the OP is a VIE and the REIT is the primary beneficiary.

The OP's assets can be used only to settle its obligations and the OP's creditors do not have recourse to the general credit of the REIT.

Topic 810 requires a primary beneficiary to present each of the following separately on the face of the balance sheet: [810-10-45-25]

— assets of a consolidated VIE that can be used to settle obligations of the consolidated VIE; and

— liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

Interpretive response: Yes. We believe a REIT may disclose in the notes to financial statements the nature of the OP's assets and liabilities if all, or substantially all, of consolidated assets and liabilities of the REIT are the assets and liabilities of the OP (or other consolidated VIEs). This is often the case because UPREITs often primarily run their operations through an OP and have minimal activity outside the OP. We understand that this analysis is consistent with the SEC staff's view.

We believe the information disclosed in the notes should be in sufficient detail to enable financial statement users to understand the REIT's involvement with the OP and the associated risks – consistent with the VIE disclosure objectives of Subtopic 810. [810-10-50-2AA]

If the OP directly consolidates VIEs (i.e. the REIT has an indirect interest in lower-level VIEs), the REIT must determine whether the lower-level VIE's assets and liabilities need to be presented separately on its consolidated balance sheet (see Question 8.2.150). The OP needs to do a similar analysis when preparing its separate financial statements).

8.2.40 Proportionate consolidation

Excerpt from ASC 810-10

General

> Proportionate Consolidation

45-14 If the investor-venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability, the provisions of paragraph 323-10-45-1 may not apply in some industries. For example, in certain industries the investor-venturer may account in its financial statements for its pro rata share of the assets, liabilities, revenues, and expenses of the venture. Specifically, a proportionate gross financial statement presentation is not appropriate for an investment in an unincorporated legal entity accounted for by the equity method of accounting unless the investee is in either the construction industry (see paragraph 910-810-45-1) or an extractive industry (see paragraphs 930-810-45-1 and 932-810-45-1). An entity is in an extractive industry only if its activities are limited to the extraction of mineral resources (such as oil and gas exploration and production) and not if its activities involve related activities such as refining, marketing, or transporting extracted mineral resources.

Excerpt from ASC 910-810

45-1 Paragraph 810-10-45-14 explains that a proportionate gross financial statement presentation is not appropriate for an investment in an unincorporated legal entity accounted for by the equity method of accounting unless the investee is in either the construction industry (as discussed in this Topic) or an extractive industry (see paragraphs 930-810-45-1 and 932-810-45-1).

Excerpt from ASC 932-810

> Proportionate Consolidation

45-1 Paragraph 810-10-45-14 explains that a proportionate gross financial statement presentation is not appropriate for an investment in an unincorporated legal entity accounted for by the equity method of accounting unless the investee is in either the construction industry or an extractive industry (as discussed in this Topic and paragraph 930-810-45-1). As indicated in that paragraph, an entity is in an extractive industry only if its activities are limited to the extraction of mineral resources (such as oil and gas **exploration** and **production**) and not if its activities involve related activities such as refining, marketing, or transporting extracted mineral resources.

Excerpt from ASC 970-323

> Undivided Interests

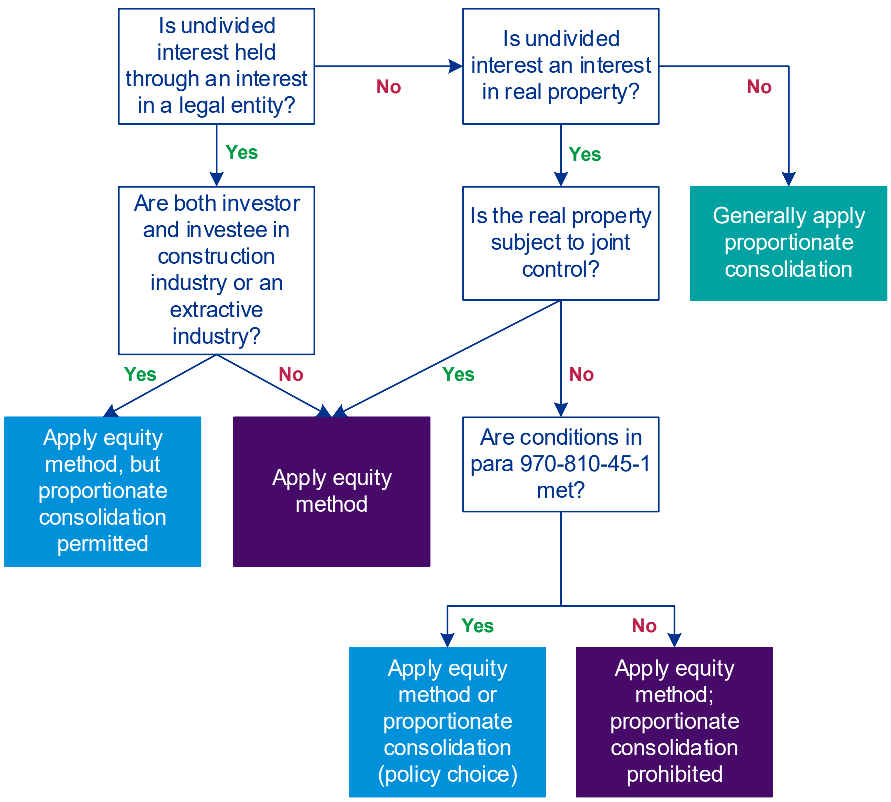
25-12 If real property owned by undivided interests is subject to **joint control** by the owners, the investor-venturers shall not present their investments by accounting for their pro rata share of the assets, liabilities, revenues, and expenses of the ventures. Most real estate ventures with ownership in the form of undivided interests are subject to some level of joint control. Accordingly, such investments shall be presented in the same manner as investments in noncontrolled partnerships.

An investment accounted for under the equity method is presented on the balance sheet as a single amount. However, there are exceptions to one-line presentation in which the investor's proportionate share of the investee's individual assets, liabilities and components of comprehensive income are presented in the investor's consolidated financial statements. This presentation is often referred to as 'proportionate consolidation'. [810-10-45-14, 910-810-45-1, 930-810-45-1, 932-810-45-1, 970-810-45-1]

Question 8.2.210
When is it acceptable to apply proportionate consolidation?

Interpretive response: There are limited situations in which proportionate consolidation is acceptable.

The following decision tree highlights the key considerations when determining which accounting method to apply to an undivided interest.



Investors in the construction and extractive industries

Investors in the construction and extractive industries that must apply the equity method to their investees operating in the same industry may present their proportionate share of the investee's individual assets, liabilities and components of comprehensive income in their financial statements. However, such investors still apply the recognition and measurement principles of Topic 323. [810-10-45-14, 910-810-45-1, 930-810-45-1, 932-810-45-1]

Undivided interests

Generally, if the undivided interest is held through a legal entity, proportionate consolidation is permitted only if both the investor and investee are in either the construction industry or an extractive industry (see above). In contrast, proportionate consolidation is applied when an undivided interest is held directly instead of through a legal entity.

However, additional analysis is necessary if the undivided interest is in real property.

An investor may present an undivided interest in real property that is not subject to joint control using proportionate consolidation if the investor: [970-810-45-1]

— is entitled to only its pro rata share of income;
— responsible to pay only its pro rata share of expenses; and
— severally liable only for indebtedness it incurs in connection with its interest in the property.

Section 2.3.50 of KPMG Handbook, Equity method of accounting, provides additional guidance on proportionate consolidation.

8.3 Disclosure

8.3.10 General

Excerpt from ASC 810-10

General

> Consolidation Policy

50-1 Consolidated financial statements shall disclose the consolidation policy that is being followed. In most cases this can be made apparent by the headings or other information in the financial statements, but in other cases a note to financial statements is required.

> Parent with a Less-Than-Wholly-Owned Subsidiary

50-1A A **parent** with one or more less-than-wholly-owned **subsidiaries** shall disclose all of the following for each reporting period:

a. Separately, on the face of the consolidated financial statements, both of the following:
   1. The amounts of consolidated net income and consolidated comprehensive income
   2. The related amounts of each attributable to the parent and the **noncontrolling interest**.
b. Either in the notes or on the face of the consolidated income statement, amounts attributable to the parent for any of the following, if reported in the consolidated financial statements:

1. Income from continuing operations
2. Discontinued operations
3. Subparagraph superseded by Accounting Standards Update No. 2015-01.

c. Either in the consolidated statement of changes in equity, if presented, or in the notes to consolidated financial statements, a reconciliation at the beginning and the end of the period of the carrying amount of total equity (net assets), equity (net assets) attributable to the parent, and equity (net assets) attributable to the noncontrolling interest. That reconciliation shall separately disclose all of the following:
   1. Net income
   2. Transactions with owners acting in their capacity as owners, showing separately contributions from and distributions to owners
   3. Each component of other comprehensive income.
d. In notes to the consolidated financial statements, a separate schedule that shows the effects of any changes in a parent's ownership interest in a subsidiary on the equity attributable to the parent.

Example 2 (see paragraph 810-10-55-4G) illustrates the application of the guidance in this paragraph.

> Deconsolidation of a Subsidiary

50-1B In the period that either a subsidiary is deconsolidated or a group of assets is derecognized in accordance with paragraph 810-10-40-3A, the parent shall disclose all of the following:

a. The amount of any gain or loss recognized in accordance with paragraph 810-10-40-5
b. The portion of any gain or loss related to the remeasurement of any retained investment in the former subsidiary or group of assets to its fair value
c. The caption in the income statement in which the gain or loss is recognized unless separately presented on the face of the income statement
d. A description of the valuation technique(s) used to measure the fair value of any direct or indirect retained investment in the former subsidiary or group of assets
e. Information that enables users of the parent's financial statements to assess the inputs used to develop the fair value in item (d)
f. The nature of continuing involvement with the subsidiary or entity acquiring the group of assets after it has been deconsolidated or derecognized
g. Whether the transaction that resulted in the deconsolidation or derecognition was with a related party
h. Whether the former subsidiary or entity acquiring a group of assets will be a related party after deconsolidation.

> A Change in the Difference Between Parent and Subsidiary Fiscal Year-Ends

50-2 An entity should make the disclosures required pursuant to Topic 250. This paragraph applies to all entities that change (or eliminate) a previously existing difference between the reporting periods of a parent and a consolidated entity or an investor and an equity method investee. This paragraph does not apply in situations in which a parent entity or an investor changes its fiscal year-end.

> Implementation Guidance

>> Deconsolidation of a Subsidiary

55-4A All of the following are circumstances that result in deconsolidation of a subsidiary under paragraph 810-10-40-4:

a. A parent sells all or part of its ownership interest in its subsidiary and, as a result, the parent no longer has a controlling financial interest in the subsidiary.
b. The expiration of a contractual agreement that gave control of the subsidiary to the parent.
c. The subsidiary issues shares, which reduces the parent's ownership interest in the subsidiary so that the parent no longer has a controlling financial interest in the subsidiary.
d. The subsidiary becomes subject to the control of a government, court, administrator, or regulator.

Excerpt from ASC 805-10

> Business Combinations Occurring During a Current Reporting Period or After the Reporting Date but Before the Financial Statements Are Issued

50-1 The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

a. During the current reporting period
b. After the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25).

> The Financial Effects of Adjustments That Relate to Business Combinations That Occurred in the Current or Previous Reporting Periods

50-5 The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods.

A parent that prepares consolidated financial statements needs to consider the disclosure requirements of both Topic 805 (business combinations) and Subtopic 810-10.

— **Topic 805 disclosures.** These disclosure requirements are intended to provide financial statement users information about the effects of initially consolidating a subsidiary in a business combination.

— **Subtopic 810-10 general disclosures.** These general disclosure requirements are primarily intended to enable users of consolidated financial statements to: [810-10-50-1A]
  – identify and distinguish between amounts attributable to the parent and the NCI; and
  – understand changes in those amounts resulting from current period activity, including transactions between the controlling interest and the NCI holder(s).

Subtopic 810-10 contains additional disclosure requirements for variable interests in VIEs (see section 8.2.30).

Section 8.3.50 contains a comprehensive disclosure example from Subtopic 810-10.

Question 8.3.10

What disclosures are required when a parent initially consolidates a business?

Interpretive response: A parent provides the disclosures in Topic 805 for each material business combination. We believe this includes business combinations that occurred in the prior periods presented.

The objectives of the disclosures are to enable financial statement users to evaluate: [805-10-50-1, 50-5]

— the nature and financial effect of a business combination that occurs either during the current reporting period, or after the reporting date but before the financial statements are issued (available to be issued); and

— the financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods.

Topic 805 includes several requirements to provide specific disclosures that are consistent with these objectives. However, if the required disclosures do not achieve the above objectives, a parent needs to disclose any additional information that is necessary to meet the objectives.

Topic 805 requires specific disclosure about:

— the general nature of the acquisition transaction;
— the consideration transferred;
— contingent consideration and indemnification assets;
— certain acquired receivables;
— the assets acquired and liabilities assumed;
— goodwill;
— bargain purchases;
— equity interests not acquired – i.e. NCI;
— business combinations achieved in stages – i.e. step acquisitions;
— transactions accounted for separately (e.g. preexisting relationships); and

— post-acquisition effects to the consolidated income statement and supplemental pro forma information (public entities only).

See section 13 of KPMG Handbook, Business combinations, for guidance on the disclosures required for business combinations.

Question 8.3.20

What disclosures are required when a parent initially consolidates a subsidiary in an asset acquisition?

Interpretive response: The Acquisition of Assets Rather than a Business Subsections of Subtopic 805-50 provide guidance on accounting for asset acquisitions. Included in this guidance are acquisitions that result in the consolidation of a subsidiary that is not a business and not a VIE. [805-50-15-4]

Subtopic 805-50 does not require specific disclosures for asset acquisitions. Acquirers should consider relevant disclosure requirement in other Subtopics that may apply to the transaction, such as (not exhaustive):

— Subtopic 350-30 (intangible assets);
— Subtopic 360-10 (property, plant and equipment);
— Subtopic 450-20 (loss contingencies);
— Subtopic 730-10 (R&D costs); and
— Subtopic 845-10 (nonmonetary exchanges).

See KPMG Handbook, Asset acquisitions, for guidance on accounting for asset acquisitions.

Question 8.3.30

Are there additional MD&A disclosures that an SEC registrant needs to consider about consolidation?

Interpretive response: Yes. If the enterprise is subject to SEC reporting requirements, it must discuss in MD&A variable interests that "have, or are reasonably likely to have, a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors."

This requirement applies regardless of whether the variable interest is in a legal entity that meets the definition of a VIE. The SEC rules further indicate that the definition of variable interest is intended to be consistent with the concept of a variable interest that is included in Topic 810. [S-K Item 303(a)(4)]

Question 8.3.40#

Are there additional disclosures or presentation matters that a parent should consider?

Interpretive response: A parent should also consider the following presentation and disclosure guidance about:

- application of the registered money market funds scope exception (see section 2.3.30 and Question 2.3.210);
- amounts allocated from a master fund when a feeder fund is subject to SEC reporting requirements (see Question 2.3.140);
- application of the private company common control alternative(see section 2.6.10);
- a subsidiary's bankruptcy filing in the subsequent events period (see Question 2.5.50);
- events occurring between a subsidiary's and parent's year-ends when those year-ends are different or when a lag period exists (see section 7.4.10, and Questions 7.4.80 and 7.4.140);
- situations in which accounting policies are not conformed between the parent and subsidiary (see Question 7.4.20);
- changes in a lag period (see Question 7.4.70);
- how to present common control mergers (see section 7.3);
- how to present beneficial interests when consolidating securitization structures (see Question 7.3.150);
- how the hypothetical liquidation at book value (HLBV) method is used to attribute amounts between parent and NCI (see Question 7.5.10);
- how to present income tax expense when NCI exists (see Question 7.5.90);
- measuring NCI with redemption features when it is not currently redeemable (see Question 7.5.120);
- the accounting policy elected to account for transaction costs relating to transactions with NCI holder(s) while retaining control (see Question 7.5.170);
- how to present gain or loss on deconsolidation of a subsidiary (see Questions 7.6.20 and 7.6.40);
- amounts credited to equity of the parent on deconsolidation of a subsidiary that result from previously redeemable NCI (see Question 7.6.100);
- changes in the carrying amount of redeemable NCI (see Question 8.2.90); and
- the assets and liabilities of an operating partnership that are consolidated by an UPREIT (see Question 8.2.200).

8.3.20 VIEs

Excerpt from ASC 810-10

Variable Interest Entities

50-2AA The principal objectives of this Subsection's required disclosures are to provide financial statement users with an understanding of all of the following:

a. The significant judgments and assumptions made by a reporting entity in determining whether it must do any of the following:
   1. Consolidate a **variable interest entity** (VIE)
   2. Disclose information about its involvement in a VIE.
b. The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by a reporting entity in its statement of financial position, including the carrying amounts of such assets and liabilities.
c. The nature of, and changes in, the risks associated with a reporting entity's involvement with the VIE.
d. How a reporting entity's involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows.

50-2AB A reporting entity shall consider the overall objectives in the preceding paragraph in providing the disclosures required by this Subsection. To achieve those objectives, a reporting entity may need to supplement the disclosures otherwise required by this Subsection, depending on the facts and circumstances surrounding the VIE and a reporting entity's interest in that VIE.

50-2AC The disclosures required by this Subsection may be provided in more than one note to the financial statements, as long as the objectives in paragraph 810-10-50-2AA are met. If the disclosures are provided in more than one note to the financial statements, the reporting entity shall provide a cross reference to the other notes to the financial statements that provide the disclosures prescribed in this Subsection for similar entities.

> Primary Beneficiary of a VIE

50-3 The **primary beneficiary** of a VIE that is a **business** shall provide the disclosures required by other guidance. The primary beneficiary of a VIE that is not a business shall disclose the amount of gain or loss recognized on the initial consolidation of the VIE. In addition to disclosures required elsewhere in this Topic, the primary beneficiary of a VIE shall disclose all of the following:

a. Subparagraph superseded by Accounting Standards Update No. 2009-17
b. Subparagraph superseded by Accounting Standards Update No. 2009-17

bb. The carrying amounts and classification of the VIE's assets and liabilities in the statement of financial position that are consolidated in accordance with the Variable Interest Entities Subsections, including qualitative information about the relationship(s) between those assets and liabilities. For example, if the VIE's assets can be used only to settle obligations of the VIE, the reporting entity shall disclose qualitative information about the nature of the restrictions on those assets.

c. Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the general credit of the primary beneficiary
d. Terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests that could require the reporting entity to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.

A VIE may issue voting equity interests, and the entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and the VIE's assets can be used for purposes other than the settlement of the VIE's obligations, the disclosures in paragraph 810-10-50-3(bb) through (d) are not required.

> Nonprimary Beneficiary Holder of a Variable Interest in a VIE

50-4 In addition to disclosures required by other guidance, a reporting entity that holds a variable interest in a VIE, but is not the VIE's primary beneficiary, shall disclose:

a. The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position that relate to the reporting entity's variable interest in the VIE.
b. The reporting entity's maximum exposure to loss as a result of its involvement with the VIE, including how the maximum exposure is determined and the significant sources of the reporting entity's exposure to the VIE. If the reporting entity's maximum exposure to loss as a result of its involvement with the VIE cannot be quantified, that fact shall be disclosed.
c. A tabular comparison of the carrying amounts of the assets and liabilities, as required by (a) above, and the reporting entity's maximum exposure to loss, as required by (b) above. A reporting entity shall provide qualitative and quantitative information to allow financial statement users to understand the differences between the two amounts. That discussion shall include, but is not limited to, the terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the reporting entity to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.
d. Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the reporting entity's variable interest in the VIE is encouraged.
e. If applicable, significant factors considered and judgments made in determining that the power to direct the activities of a VIE that most significantly impact the VIE's economic performance is shared in accordance with the guidance in paragraph 810-10-25-38D.

> Related to Topic 860 Disclosures

50-5 Paragraph superseded by Accounting Standards Update No. 2009-17.

> Primary Beneficiaries or Other Holders of Interests in VIEs

50-5A A reporting entity that is a primary beneficiary of a VIE or a reporting entity that holds a variable interest in a VIE but is not the entity's primary beneficiary shall disclose all of the following:

a. Its methodology for determining whether the reporting entity is the primary beneficiary of a VIE, including, but not limited to, significant judgments and assumptions made. One way to meet this disclosure requirement would be to provide information about the types of involvements a reporting entity considers significant, supplemented with information about how the significant involvements were considered in determining whether the reporting entity is the primary beneficiary.
b. If facts and circumstances change such that the conclusion to consolidate a VIE has changed in the most recent financial statements (for example, the VIE was previously consolidated and is not currently consolidated), the primary factors that caused the change and the effect on the reporting entity's financial statements.
c. Whether the reporting entity has provided financial or other support (explicitly or implicitly) during the periods presented to the VIE that it was not previously contractually required to provide or whether the reporting entity intends to provide that support, including both of the following:
    1. The type and amount of support, including situations in which the reporting entity assisted the VIE in obtaining another type of support
    2. The primary reasons for providing the support.
d. Qualitative and quantitative information about the reporting entity's involvement (giving consideration to both explicit arrangements and implicit variable interests) with the VIE, including, but not limited to, the nature, purpose, size, and activities of the VIE, including how the VIE is financed. Paragraphs 810-10-25-49 through 25-54 provide guidance on how to determine whether a reporting entity has an implicit variable interest in a VIE.

50-5B A VIE may issue voting equity interests, and the entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a **business** and the VIE's assets can be used for purposes other than the settlement of the VIE's obligations, the disclosures in the preceding paragraph are not required.

> Scope-Related Disclosures

50-6 A reporting entity that does not apply the guidance in the Variable Interest Entities Subsections to one or more VIEs or potential VIEs because of the condition described in paragraph 810-10-15-17(c) shall disclose all the following information:

a. The number of **legal entities** to which the guidance in the Variable Interest Entities Subsections is not being applied and the reason why the information required to apply this guidance is not available
b. The nature, purpose, size (if available), and activities of the legal entities and the nature of the reporting entity's involvement with the legal entities
c. The reporting entity's maximum exposure to loss because of its involvement with the legal entities

d. The amount of income, expense, purchases, sales, or other measure of activity between the reporting entity and the legal entities for all periods presented. However, if it is not practicable to present that information for prior periods that are presented in the first set of financial statements for which this requirement applies, the information for those prior periods is not required.

50-7 Paragraph superseded by Accounting Standards Update No. 2009-17.

50-8 Paragraph superseded by Accounting Standards Update No. 2009-17.

> Aggregation of Certain Disclosures

50-9 Disclosures about VIEs may be reported in the aggregate for similar entities if separate reporting would not provide more useful information to financial statement users. A reporting entity shall disclose how similar entities are aggregated and shall distinguish between:

a. VIEs that are not consolidated because the reporting entity is not the primary beneficiary but has a variable interest
b. VIEs that are consolidated.

In determining whether to aggregate VIEs, the reporting entity shall consider quantitative and qualitative information about the different risk and reward characteristics of each VIE and the significance of each VIE to the entity. The disclosures shall be presented in a manner that clearly explains to financial statement users the nature and extent of an entity's involvement with VIEs.

50-10 A reporting entity shall determine, in light of the facts and circumstances, how much detail it shall provide to satisfy the requirements of the Variable Interest Entities Subsections. A reporting entity shall also determine how it aggregates information to display its overall involvements with VIEs with different risk characteristics. The reporting entity must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users to understand the reporting entity's financial position. For example, a reporting entity shall not obscure important information by including it with a large amount of insignificant detail. Similarly, a reporting entity shall not disclose information that is so aggregated that it obscures important differences between the types of involvement or associated risks.

Subtopic 810-10 contains disclosure requirements for enterprises involved with VIEs – one set for primary beneficiaries and another set for all other variable interest holders. It also contains broad objectives for a variable interest holder's VIE disclosures.

Under these objectives, VIE disclosures should provide financial statement users with an understanding of all of the following: [810-10-50-2AA]

— the significant judgments and assumptions made in determining whether the enterprise must consolidate a VIE and/or disclose its involvement with a VIE;

— the carrying amount of, and nature of restrictions on, a consolidated VIE's assets and liabilities;

- the nature of, and changes to, the risks associated with involvement with a VIE; and
- how the involvement with the VIE affects the enterprise's financial position, financial performance and cash flows.

The specific disclosure requirements for each type of enterprise are consistent with these objectives. However, if the required disclosures do not achieve the above objectives in a given circumstance, the enterprise needs to disclose any additional information that is necessary to meet the objectives.

Question 8.3.50

Can an enterprise exclude the VIE disclosures if the information is difficult to obtain?

Interpretive response: No. There may be circumstances in which it will be difficult for an enterprise to obtain the information necessary to comply with the VIE disclosure requirements. For example, an enterprise may have difficulty obtaining financial statements if it is not the legal owner or primary beneficiary of the VIE or if the VIE does not prepare financial statements or other financial information. Nevertheless, there is no exemption from the disclosure requirements in these circumstances.

As a result, an enterprise that becomes involved with a VIE should ensure that it has the contractual right and appropriate procedures in place to obtain the necessary information to comply with the disclosure requirements.

Question 8.3.60

Are consolidated VIEs in the scope of management's ICFR report?

Interpretive response: Yes. A registrant that consolidates a VIE is expected to include the VIE in management's ICFR report.

When a registrant consolidates a VIE, it does so because it controls the VIE. In this case, the SEC staff believes the registrant likely has the right or authority to assess the internal controls of the consolidated VIE. Therefore, a registrant that becomes involved with a VIE should ensure that it has the contractual right and appropriate controls and procedures in place to obtain the necessary information to evaluate a consolidated VIE's internal controls. [2009 AICPA Conf]

Exception for certain VIEs created before December 15, 2003

The SEC staff indicated that a rare exception to the inclusion of a VIE in management's ICFR report may apply to consolidated VIEs that existed before December 15, 2003 for which the registrant does not possess the right or authority to assess the consolidated VIE's internal controls. [2009 AICPA Conf]

This exception differs from the information-out scope exception to Subtopic 810-10, in which an enterprise is not required to even apply the VIE consolidation model to a legal entity created before December 31, 2003 if it made exhaustive but unsuccessful efforts to obtain the information necessary to apply the VIE consolidation model (see section 2.3.30).

Specific disclosures

Question 8.3.70
What are the principal disclosures for consolidated and nonconsolidated VIEs and the relevant applicability?

Interpretive response: The principal disclosures for consolidated and nonconsolidated VIEs and their applicability are summarized as follows.

	Primary beneficiary	Other variable interest holder
Information required to be disclosed		
Methodology (including significant judgments and assumptions) for determining whether the enterprise is the primary beneficiary of a VIE	✓	✓
If applicable, the primary factors that caused a change in the enterprise's primary beneficiary status and the effect on the holder's financial statements	✓	✓
If the enterprise has provided explicit or implicit support to the VIE that was not previously contractually required or whether the enterprise intends to provide such support; this includes the type, amount, and primary reasons for providing the support	✓	✓
Qualitative and quantitative information about the enterprise's explicit and implicit involvement with the VIE; this includes, but is not limited to, the nature, purpose, size, and activities of the VIE, and how the VIE is financed	✓	✓
The carrying amounts and classification of the assets and liabilities on the enterprise's balance sheet that relate to its variable interest(s) in the VIE	✗	✓
The enterprise's maximum exposure to loss as a result of its involvement with the VIE, including how it is determined and the significant sources of exposure to the VIE (see Question 8.2.70)	✗	✓
A tabular comparison of the carrying amounts of the VIE's assets and liabilities and the enterprise's maximum exposure to loss from both explicit and implicit variable interests; this includes qualitative and quantitative information about differences between the two amounts	✗	✓

	Primary beneficiary	Other variable interest holder
Information required to be disclosed		
Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the enterprise's variable interest(s)	✗	✓
If applicable, significant factors considered and judgments made in determining that the power to direct the activities that most significantly impact the VIE's economic performance is shared	✗	✓
Gain or loss recognized on the initial consolidation of the VIE	✓ (if VIE is not a business)	N/A
The carrying amounts and classification of the VIE's assets and liabilities that are consolidated	✓	N/A
Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the general credit of the primary beneficiary	✓	N/A
Terms of arrangements that could require the enterprise to provide financial support to the VIE; this includes events or circumstances that could expose the enterprise to a loss	✓	✗

Question 8.3.80

What is the 'maximum exposure to loss' when an enterprise is not the primary beneficiary of a VIE?

Interpretive response: An enterprise's maximum exposure to loss is the maximum loss that could potentially be recorded through net income in future periods as a result of its explicit or implicit variable interest in a VIE. The enterprise determines its maximum exposure to loss without considering the probability of the losses actually occurring. [810-10-50-4(b)]

We believe an enterprise should consider future funding commitments (e.g. capital call requirements, etc.) and other potential costs in addition to its existing variable interests when determining the maximum loss amount.

Aggregating disclosures

Question 8.3.90

What are some qualitative factors an enterprise considers when determining whether to aggregate disclosures?

Interpretive response: If an enterprise elects to aggregate its VIE disclosures, it considers the needs of the financial statement users, including the level of disaggregation that would provide them with the most useful information. An enterprise cannot aggregate its disclosures if disaggregated information would provide more meaningful information. [810-10-50-9]

An enterprise may choose to aggregate disclosures if it adheres to the following guidelines:

— only similar VIEs are aggregated;

— VIEs in which it is the primary beneficiary cannot be aggregated with VIEs in which it is not the primary beneficiary even if those VIEs are similar; and

— even similar VIEs may have to be disaggregated if disaggregated information would provide more meaningful information to financial statement users.

We believe an enterprise should consider qualitative factors relevant to its variable interests in making its determination to aggregate VIE disclosures. For example, we believe VIEs that have the following characteristics that are similar may be aggregated (unless disaggregated information would provide more meaningful information):

— purpose and design;
— risks that the VIEs were designed to create and pass on to their variable interest holders;
— extent of the enterprise's continuing involvement with the VIEs; and
— size and nature of the VIEs' balance sheets.

Question 8.3.100

Must an enterprise provide VIE disclosures when none of its individual variable interests are significant, but the aggregate interest is?

Interpretive response: Yes. We believe an enterprise should evaluate the significance of its variable interests individually and in the aggregate in relation to its consolidated financial position, results of operations and cash flows. As a result, individually insignificant variable interests should be disclosed if, when aggregated with similar variable interests in other VIEs, the aggregated variable interests are significant to the enterprise.

When considering its variable interests in the aggregate, we believe the enterprise should aggregate only those VIEs (and variable interests) that are similar (see Question 8.3.90).

8.3.30 Private company alternative#

Excerpt from ASC 810-10

Variable Interest Entities

> Accounting Alternative for Entities under Common Control

50-2AG A reporting entity that neither consolidates nor applies the requirements of the Variable Interest Entities Subsections to a **legal entity** under common control because it meets the criteria in paragraph 810-10-15-17AD shall disclose the following:

a. The nature and risks associated with a reporting entity's involvement with the legal entity under common control.
b. How a reporting entity's involvement with the legal entity under common control affects the reporting entity's financial position, financial performance, and cash flows.
c. The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position resulting from its involvement with the legal entity under common control.
d. The reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control. If the reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control cannot be quantified, that fact shall be disclosed.
e. If the reporting entity's maximum exposure to loss (as required by (d)) exceeds the carrying amount of the assets and liabilities as described in (c), qualitative and quantitative information to allow users of financial statements to understand the excess exposure. That information shall include, but is not limited to, the terms of the arrangements, considering both explicit and implicit arrangements, that could require the reporting entity to provide financial support (for example, implicit guarantee to fund losses) to the legal entity under common control, including events or circumstances that could expose the reporting entity to a loss.

50-2AH In applying the disclosure guidance in paragraph 810-10-50-2AG(d) through (e), a reporting entity under common control shall consider exposures through implicit guarantees. Determining whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:

a. The **private company** (reporting entity) has an economic incentive to act as a guarantor or to make funds available.
b. The private company (reporting entity) has acted as a guarantor for or made funds available to the legal entity in the past.

50-2AI In disclosing information about the legal entity under common control, a private company (reporting entity) shall present these disclosures in addition to the disclosures required by other guidance (for example, in Topics 460 on guarantees, Topic 850 on related party disclosures, and Topic 842 on leases).

Those disclosures could be combined in a single note or by including cross-references within the notes to financial statements.

> Implementation Guidance

>> Accounting Alternative for Entities under Common Control

>>> Application of the Accounting Alternative

>>>> Example 14: Car Company (Reporting Entity) under Common Control with Engine Company, Tire Company, and Purse Company

55-205BF Based on the fact pattern described in paragraphs 810-10-55-205BD through 55-205BE, the following disclosures may satisfy the provisions in paragraphs 810-10-50-2AG through 50-2AI:

a. Engine Company, Inc. (Engine Co.): Engine Co. and Car Company, Inc. (the Company) are under common control. Engine Co. was created by the owner to vertically integrate the supply chain for the Company's production of vehicles. The Company's ability to generate profits depends largely on Engine Co. Engine Co. produces engines for the Company's vehicles in accordance with the Company's design specifications for those engines. Substantially all of Engine Co.'s production is sold to the Company, and Engine Co. is the sole supplier of engines to the Company. No other engines on the market could replace the engines supplied by Engine Co. The Company provides Engine Co. with management and other services (including, but not limited to, accounting, billing, and administrative duties) for which it charged a management fee of $225,684 in 20XX. The Company purchased $9,482,513 of engines during 20XX from Engine Co. Engine Co. has an outstanding loan in the amount of $600,000 due to the Company that is unsecured and accrues interest at 6 percent. The loan is subordinated to all other debt, and no specific repayment terms exist.
b. Tire Company, Inc. (Tire Co.): Tire Co. and the Company are under common control. Tire Co. was created by the owner to vertically integrate the supply chain for the Company's production of vehicles. Tire Co. produces tires for the Company's vehicles and sells a majority of those tires to the Company. The Company provides no design specifications for the tires, and many substitutes on the market could replace the tires that Tire Co. provides. The Company provides Tire Co. with management and other services (including, but not limited to, accounting, billing, and administrative duties) for which it charged a management fee of $74,568 in 20XX. Car Co. purchased $3,792,929 of tires during 20XX from Tire Co. Tire Co. has an outstanding loan in the amount of $200,000 due to the Company that is unsecured and accrues interest at 6 percent. The loan is subordinated to all other debt, and no specific repayment terms exist.
c. Both Engine Co. and Tire Co. have third-party debt, and both companies have their assets pledged as collateral for that debt. The owner of the Company, Engine Co., and Tire Co. has personally guaranteed the third-party debt of the Company, Engine Co., and Tire Co.
d. In addition to the $600,000 loan, the Company historically has been required to provide funds to Engine Co. at the request of the common owner. The Company believes that its maximum financial exposure to loss related to Engine Co. could equal all of Engine Co.'s liabilities. The book value of Engine Co.'s liabilities is $2,459,127 as of December 31, 20XX.

e. Other than the $200,000 loan, the Company has never provided any other additional funding to Tire Co. and is not contractually obligated to do so. The Company believes that its maximum financial exposure related to Tire Co. is limited to the $200,000 loan outstanding and any accrued interest as of December 31, 20XX.

A private company that elects the private company alternative (see section 2.6.10) but does not consolidate a legal entity under the VOE consolidation guidance, is required to provide the following disclosures: [810-10-50-2AG]

— the nature and risks associated with its involvement with the legal entity;
— how its involvement with the legal entity affects its financial position, financial performance and cash flows;
— the carrying amounts and classification of assets and liabilities on its balance sheet resulting from its involvement with the legal entity; and
— its maximum exposure to loss resulting from its involvement with the legal entity (or a statement that it cannot be quantified).

Maximum exposure disclosure

If the private company's maximum exposure to loss exceeds the assets and liabilities reported on its balance sheet, it should provide qualitative and quantitative information to explain the excess exposure. The discussion includes, but is not limited to, the terms of the arrangements (considering both explicit and implicit arrangements) that could require the company to provide financial support to the legal entity. This includes events or circumstances that could expose the company to a loss. [810-10-50-2AD(e)]

Determining whether the private company has promised implicit support is based on facts and circumstances. However, implicit support may exist if the private company has an economic incentive to act as a guarantor or to make funds available, or has done so in similar situations. See section 3.3 for guidance on identifying implicit variable interests. [810-10-50-2AH]

Form of disclosure

The company can combine the required disclosures in a single note in the financial statements or include cross-references within the notes to the disclosures required by other guidance such as guarantees (Topic 460), related parties (Topic 850) and leases (Topic 842). [810-10-50-2AI]

8.3.40 Collateralized financing entities

Excerpt from ASC 810-10

Variable Interest Entities

> Collateralized Financing Entities

50-20 A reporting entity that consolidates a **collateralized financing entity** and measures the financial assets and the financial liabilities using the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-

10-35-6 through 35-8 shall disclose the information required by Topic 820 on fair value measurement and Topic 825 on financial instruments for the financial assets and the financial liabilities of the consolidated collateralized financing entity.

50-21 For the less observable of the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity that is measured in accordance with the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8, a reporting entity shall disclose that the amount was measured on the basis of the more observable of the fair value of the financial liabilities and the fair value of the financial assets.

50-22 The disclosures in paragraphs 810-10-50-20 through 50-21 do not apply to the financial assets and the financial liabilities that are incidental to the operations of the **collateralized financing entity** and have carrying values that approximate fair value.

The primary beneficiary of a consolidated collateralized financing entity (CFE) may apply an alternative fair value measurement approach. The approach permits the primary beneficiary to measure the CFE's financial assets and liabilities based on either the fair value of the financial assets or financial liabilities, whichever has the more observable inputs.

A primary beneficiary that elects this measurement alternative is required to provide disclosures specific to the CFE under Subtopic 810-10. It is also subject to the relevant disclosure guidance in Topic 820 (fair value measurement) and Topic 825 (financial instruments). [810-10-50-20 - 50-22]

See section 7.3 for additional guidance on the application of the CFE measurement alternative.

8.3.50 FASB example

The following comprehensive example from Subtopic 810-10 illustrates the presentation and disclosure of NCIs in consolidated financial statements.

Excerpt from ASC 810-10

General

> Implementation Guidance

>> Example 2: Presentation and Disclosure Involving Noncontrolling Interests

55-4G This Example illustrates the application of this Subtopic's presentation and disclosure guidance by a parent with one or more less-than-wholly-owned subsidiaries.

55-4H This Example involves all of the following assumptions:

a. Entity ABC has on subsidiary, Subsidiary A.
b. The tax rate for all years is 40 percent.
c. Entity ABC has 200,000 shares of common stock outstanding and pays dividends of $10,000 each year on those common shares. Entity ABC has no potentially dilutive shares.
d. Subsidiary A has 10,000 shares of common stock outstanding and does not pay dividends.
e. Entity ABC owns all 10,000 shares in Subsidiary A for the entire year 20X1.
f. On June 30, 20X1, Subsidiary A purchases a portfolio of securities for $100,000 and classifies those securities as available for sale.
g. On December 31, 20X1, the carrying amount of the available-for-sale securities is $105,000.
h. For the year ended December 31, 20X1, the amount of Subsidiary A's net income included in the consolidated financial statements is $24,000.
i. On January 1, 20X2, Entity ABC sells 2,000 of its shares in Subsidiary A to an unrelated entity for $50,000 in cash, reducing its ownership interest from 100 percent to 80 percent
j. Immediately before the January 1, 20X2 sale, Subsidiary A's equity was as follows:

	Subsidiary A
Common stock	$ 25,000
Paid-in capital	50,000
Retained earnings	125,000
Accumulated other comprehensive income	5,000
Total equity	$ 205,000

k. The January 1, 20X2 sale of Subsidiary A's shares by Entity ABC is accounted for as an equity transaction in the consolidated financial statements, as follows:

1. A noncontrolling interest is recognized in the amount of $41,000 ($205,000 × 20 percent).
2. Additional paid-in capital attributable to Entity ABC is increased by $9,000, calculated as the difference between the cash received ($50,000) and the carrying amount of the noncontrolling interest ($41,000).
3. Additional paid-in capital attributable to Entity ABC is also increased by $1,000, which represents the carrying amount of Subsidiary A's accumulated other comprehensive income related to the ownership interest sold to the noncontrolling interest ($5,000 × 20 percent = $1,000). Accumulated other comprehensive income attributable to Entity ABC is decreased by a corresponding amount.
4. The journal entry to record the sale of Subsidiary A's shares to the noncontrolling shareholders is as follows:

Cash	50,000	
Accumulated other comprehensive income (Entity ABC)	1,000	
Noncontrolling interest		41,000
Additional paid-in capital (Entity ABC)		10,000

l. For the year ended December 31, 20X2, the amount of Subsidiary A's net income included in the consolidated financial statements is $20,000.
m. On January 1, 20X3, Entity ABC purchases 1,000 shares in Subsidiary A from the noncontrolling shareholders (50 percent of the noncontrolling interest) for $30,000 for cash, increasing its ownership interest from 80 percent to 90 percent.
n. Immediately before the January 1, 20X3 purchase, the carrying amount of the noncontrolling interest in Subsidiary A was $48,000, which included $4,000 in accumulated other comprehensive income.
o. The January 1, 20X3 purchase of shares from the noncontrolling shareholders is accounted for as an equity transaction in the consolidated financial statements, as follows:

   1. The noncontrolling interest balance is reduced by $24,000 ($48,000 × 50 percent interest acquired by Entity ABC).
   2. Additional paid-in capital of Entity ABC is decreased by $6,000, calculated as the difference between the cash paid ($30,000) and the adjustment to the carrying amount of the noncontrolling interest ($24,000).
   3. Additional paid-in capital of Entity ABC is also decreased by $2,000, which represents the carrying amount of Subsidiary A's accumulated other comprehensive income related to the ownership interest purchased from the noncontrolling shareholders ($4,000 × 50 percent - $2,000).
   4. Accumulated comprehensive income attributable to Entity ABC is increased by a corresponding amount ($2,000).
   5. The journal entry to record that purchase of Subsidiary A's shares from the noncontrolling shareholders is as follows:

Noncontrolling interest	24,000	
Additional paid-in capital (Entity ABC)	8,000	
Accumulated other comprehensive income (Entity ABC)		2,000
Cash		30,000

p. For the year ended December 31, 20X3, the amount of Subsidiary A's net income included in the consolidated financial statements is $15,000.

55-4I This This consolidated statement of financial position illustrates application of the requirement in paragraph 810-10-45-16 that Entity ABC present the noncontrolling interest in the consolidated statement of financial position within equity, but separately from the parent's equity.

Entity ABC
Consolidated Statement of Financial Position
As of December 31

	20X3	20X2
Assets:		
Cash	$ 570,000	$ 475,000
Accounts receivable	125,000	110,000
Available-for-sale securities	125,000	120,000
Plant and equipment	220,000	235,000
Total assets	$ 1,040,000	$ 940,000
Liabilities:		
Total liabilities	$ 555,000	$ 459,000

Equity:		
Entity ABC shareholders' equity:		
Common stock, $1 par	200,000	200,000
Paid-in capital	42,000	50,000
Retained earnings	194,500	167,000
Accumulated other comprehensive income	22,500	16,000
Total Entity ABC shareholders' equity	459,000	433,000
Noncontrolling interest	26,000	48,000
Total equity	485,000	481,000
Total liabilities and equity	$ 1,040,000	$ 940,000

55-4J This consolidated statement of income illustrates the requirements in paragraph 810-10-50-1A that the amounts of consolidated net income and the net income attributable to Entity ABC and the noncontrolling interest be presented separately on the face of the consolidated income statement. It also illustrates the requirement in paragraph 810-10-50-1A(b) that the amounts of income from continuing operations and discontinued operations attributable to Entity ABC should be disclosed.

Entity ABC
Consolidated Statement of Income
Year Ended December 31

	20X3	**20X2**	**20X1**
Revenues	$ 395,000	$ 360,000	$ 320,000
Expenses	(330,000)	(305,000)	(270,000)
Income from continuing operations, before tax	65,000	55,000	50,000
Income tax expense	(26,000)	(22,000)	(20,000)
Income from continuing operations, net of tax	39,000	33,000	30,000
Discontinued operations, net of tax	—	(7,000)	—
Net income	39,000	26,000	30,000
Less: Net income attributable to the noncontrolling interest	(1,500)	(4,000)	—
Net income attributable to Entity ABC shareholders	$ 37,500	$ 22,000	$ 30,000
Earnings per share–basic and diluted:			
Income from continuing operations attributable to Entity ABC common shareholders	$ 0.19	$ 0.14	$ 0.15
Discontinued operations attributable to Entity ABC common shareholders	—	(0.03)	—
Net income attributable to Entity ABC common shareholders	$ 0.19	$ 0.11	$ 0.15
Weighted-average shares outstanding, basic and diluted	200,000	200,000	200,000
Amounts attributable to Entity ABC shareholders:			
Income from continuing operations, net of tax	$ 37,500	$ 27,600	$ 30,000
Discontinued operations, net of tax	—	(5,600)	—
Net income attributable to Entity ABC shareholders	$ 37,500	$ 22,000	$ 30,000

55-4K This statement of consolidated comprehensive income illustrates the requirements in paragraph 810-10-50-1A(a) that the amounts of consolidated comprehensive income and comprehensive income attributable to Entity ABC and the noncontrolling interest be presented separately on the face of the consolidated statement in which comprehensive income is presented.

Entity ABC
Statement of Consolidated Comprehensive Income
Year Ended December 31

	20X3	20X2	20X1
Net income	$ 39,000	$ 26,000	$ 30,000
Other comprehensive income, net of tax:			
Unrealized holding gain on available-for-sale securities, net of tax	5,000	15,000	5,000
Total other comprehensive income, net of tax	5,000	15,000	5,000
Comprehensive income	44,000	41,000	35,000
Comprehensive income attributable to the noncontrolling interest	(2,000)	(7,000)	—
Comprehensive income attributable to Entity ABC shareholders	$ 42,000	$ 34,000	$ 35,000

55-4L This consolidated statement of changes in equity illustrates the requirements in paragraph 810-10-50-1A(c) that Entity ABC present a reconciliation at the beginning and the end of the period of the carrying amount of total equity, equity attributable to Entity ABC, and equity attributable to the noncontrolling interest. It also illustrates that because the noncontrolling interest is part of the equity of the consolidated group, it is presented in the statement of changes in equity.

Entity ABC
Consolidated Statement of Changes in Equity
Year Ended December 31, 20X3

		Entity ABC Shareholders				
	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Paid-in Capital	Noncontrolling Interest
Beginning Balance	$ 481,000	$ 167,000	$ 16,000	$ 200,000	$ 50,000	$ 48,000
Purchase of subsidiary shares from noncontrolling interest	(30,000)		2,000		(8,000)	(24,000)
Net income (loss)	39,000	37,500				1,500
Other comprehensive income (loss), net of tax:						
Unrealized gains on securities	5,000		4,500			500
Other comprehensive income (loss)	5,000					
Dividends paid on common stock	(10,000)	(10,000)	—	—	—	—
Ending balance	$ 485,000	$ 194,500	$ 22,500	$ 200,000	$ 42,000	$ 26,000

Entity ABC
Consolidated Statement of Changes in Equity
Year Ended December 31, 20X2

		Entity ABC Shareholders				
	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Paid-in Capital	Noncontrolling Interest
Beginning Balance	$ 400,000	$ 155,000	$ 5,000	$ 200,000	$ 40,000	$ —
Sale of subsidiary shares to noncontrolling interest	50,000		(1,000)		10,000	41,000
Net income (loss)	26,000	22,000				4,000
Other comprehensive income, net of tax:						
Unrealized gains on securities	15,000		12,000			3,000
Other comprehensive income	15,000					
Dividends paid on common stock	(10,000)	(10,000)	—	—	—	—
Ending balance	$ 481,000	$ 167,000	$ 16,000	$ 200,000	$ 50,000	$ 48,000

>> Additional Disclosure if a Parent's Ownership Interest in a Subsidiary Changes during the Period

55-4M This schedule illustrates the requirements in paragraph 810-10-50-1A(d) that Entity ABC present in notes to the consolidated financial statements a separate schedule that shows the effects of changes in Entity ABC's ownership interest in its subsidiary on Entity ABC's equity. This schedule is only required if the parent's ownership interest in a subsidiary changes in any periods presented in the consolidated financial statements.

Entity ABC
Notes to Consolidated Financial Statements
Net Income Attributable to Entity ABC and
Transfers (to) from the Noncontrolling Interest
Year Ended December 31

The purpose of this schedule is to disclose the effects of changes in Entity ABC's ownership interest in its subsidiary on Entity ABC's equity.

	20X3	20X2	20X1
Net income attributable to Entity ABC shareholders	$ 37,500	$ 22,000	$ 30,000
Transfers (to) from the noncontrolling interest			
Increase in Entity ABC's paid-in capital for sale of 2,000 Subsidiary A common shares	—	10,000	—
Decrease in Entity ABC's paid-in capital for purchase of 1,000 Subsidiary A common shares	(8,000)	—	—
Net transfers (to) from noncontrolling interest	(8,000)	10,000	—
Change from net income attributable to Entity ABC shareholders and transfers (to) from noncontrolling interest	$ 29,500	$ 32,000	$ 30,000

9. Other topics

Detailed contents

9.1 How the standard works

This chapter discusses miscellaneous items in Topic 810 not covered in pervious chapters. The items covered in the chapter relate to the following:

- entities controlled by contract;
- combined financial statements;
- parent-only financial statements; and
- NFP entities.

9.2 Entities controlled by contract

Excerpt from ASC 810-10

Consolidation of Entities Controlled by Contract

> Overall Guidance

15-18 The Consolidation of Entities Controlled by Contract Subsections follow the same Scope and Scope Exceptions as outlined in the General Subsection of this Subtopic, see paragraph 810-10-15-1, with specific qualifications and exceptions noted below.

> Entities

15-19 The guidance in the Consolidation of Entities Controlled by Contract Subsections applies to all entities that are not determined to be **variable interest entities** (VIEs) (see the Variable Interest Entities Subsection of this Section) if the circumstances are similar to those described in the Consolidation of Entities Controlled by Contract Subsections. For example, there may be industries other than the health care industry in which a contractual management arrangement is established under circumstances similar to those addressed in the Consolidation of Entities Controlled by Contract Subsections.

> Transactions

15-20 The guidance in the Consolidation of Entities Controlled by Contract Subsections applies, in part, to contractual management arrangements with both of the following characteristics:

a. Relationships between entities that operate in the health care industry including the practices of medicine, dentistry, veterinary science, and chiropractic medicine (for convenience, entities engaging in these practices are collectively referred to as physician practices)
b. Relationships in which the physician practice management entity does not own the majority of the outstanding voting equity instruments of the physician practice, whether because the physician practice management entity is precluded by law from owning those equity instruments or because the physician practice management entity has elected not to own those equity instruments.

As stated in the preceding paragraph, there may be industries other than the health care industry in which a contractual management arrangement is established under circumstances similar to those addressed in the Consolidation of Entities Controlled by Contract Subsections.

15-21 A physician practice management entity can establish a controlling financial interest in a physician practice through contractual management arrangements. Specifically, a controlling financial interest exists if, for a requisite period of time, the physician practice management entity has control over the physician practice and has a financial interest in the physician practice that meets all six of the requirements listed in the following paragraph. That paragraph contains guidance that describes how those six requirements are to be applied. Paragraph 810-10-55-206 contains a decision tree illustrating the basic analysis called for by both the six requirements and the presumptive, but not the other, interpretive guidance

15-22 If all of the following requirements are met, then the physician practice management entity has a controlling financial interest in the physician practice:

a. Term. The contractual arrangement between the physician practice management entity and the physician practice has both of the following characteristics:
   1. Has a term that is either the entire remaining legal life of the physician practice entity or a period of 10 years or more
   2. Is not terminable by the physician practice except in the case of gross negligence, fraud, or other illegal acts by the physician practice management entity, or bankruptcy of the physician practice management entity.

b. Control. The physician practice management entity has exclusive authority over all decision making related to both of the following:
   1. Ongoing, major, or central operations of the physician practice, except for the dispensing of medical services. This must include exclusive **decision-making authority** over scope of services, patient acceptance policies and procedures, pricing of services, negotiation and execution of contracts, and establishment and approval of operating and capital budgets. This authority also must include exclusive decision-making authority over issuance of debt if debt financing is an ongoing, major, or central source of financing for the physician practice.
   2. Total practice compensation of the licensed medical professionals as well as the ability to establish and implement guidelines for the selection, hiring, and firing of them.

c. Financial interest. The physician practice management entity must have a significant financial interest in the physician practice that meets both of the following criteria:
   1. Is unilaterally saleable or transferable by the physician practice management entity
   2. Provides the physician practice management entity with the right to receive income, both as ongoing fees and as proceeds from the sale of its interest in the physician practice, in an amount that fluctuates based on the performance of the operations of the physician practice and the change in the fair value thereof.

Term, control, financial interest, and so forth are further described in paragraphs 810-10-25-63 through 25-79.

> General Guidance

25-61 The information necessary to evaluate the requirements in paragraph 810-10-15-22 may or may not be documented in the contractual agreements that underlie the relationship between the physician practice management entity and the physician practice. If the information is documented in those agreements, then that documentation should be used to evaluate whether the requirements are met regardless of whether the respective parties are currently behaving in accordance with the documented provisions. To the extent that some of the information is not documented, then all of the requirements in that paragraph are still applicable; however, the facts and circumstances of the relationship should be evaluated to determine whether the requirements are met.

25-62 Relevant facts and circumstances include the legal rights and obligations of each party absent the documentation and the reasons for any undocumented provisions. With respect to the latter, in a situation in which neither the physician practice management entity nor its nominee owns any of the outstanding voting equity interests of the physician practice, lack of documentation of a right of the physician practice management entity may be caused by the fact that the physician practice shareholders have not transferred that right to the physician practice management entity. This same lack of documentation in a situation in which the physician practice management entity and its nominee collectively own all of the outstanding voting equity instruments of the physician practice may be caused by the fact that there is less discipline to document absent third-party physician practice owners.

> Term

25-63 The term of the arrangement is to be determined based on its substance as opposed to its form; thus, both the original stated contract term and renewal or cancellation provisions must be considered. For example, an arrangement with an initial stated term of 5 years that has a single 5-year renewal option that is unilaterally exercisable by the physician practice management entity is considered to have an adequate term because it is collectively a 10-year contract.

25-64 In the circumstances that are the subject of the Consolidation of Entities Controlled by Contract Subsections, it is appropriate, in being explicit about the duration of the management arrangements, that the term be defined as a period of 10 years or more. Defining the term as a period of 10 years or more is only for purposes of the Consolidation of Entities Controlled by Contract Subsections. It is not intended that a term of 10 years or more be applied in other consolidation situations.

> Control

25-65 The following guidance applies to the evaluation of the control requirement in paragraph 810-10-15-22(b) for identifying a physician practice management arrangement, or similar contractual management arrangement, as a controlling financial interest:

a. **Nominee shareholder** situation, presumption of control—need to evaluate more than just the terms of the contractual management agreement
b. Nominee shareholder situation—need to evaluate more than just the terms of the contractual management agreement
c. Binding arbitration provisions
d. Powers limited by law
e. Scope of service decisions
f. Physician cosigning provisions

>> Nominee Shareholder Situation, Presumption of Control—Need to Evaluate More Than Just the Terms of the Contractual Management Agreement

25-66 If a majority of the outstanding voting equity instruments of the physician practice is owned by a nominee shareholder of the physician practice management entity (or by the physician practice management entity itself and its nominee shareholder), then a rebuttable presumption exists that the physician practice management entity controls the physician practice. This presumption is rebutted if others (including any other physician practice shareholders and physicians employed by the physician practice) have been granted rights by the physician practice management entity (either pursuant to the management agreement or through its nominee shareholder; by the physician practice, pursuant to its provisions for corporate governance; and so forth), such that the physician practice management entity does not have exclusive decision-making authority over the decisions that constitute the control requirements. Conversely, the presumption cannot be rebutted if the physician practice management entity has exclusive **decision-making authority** over the decisions that constitute those control requirements, whether the physician practice management entity obtained it through the management agreement, through its nominee, or pursuant to the provisions for corporate governance of the physician practice.

>> Nominee Shareholder Situation—Need to Evaluate More Than Just the Terms of the Contractual Management Agreement

25-67 If less than a majority of the outstanding voting equity instruments of the physician practice is owned by a nominee shareholder of the physician practice management entity (or by the physician practice management entity itself and the nominee shareholder), then no presumption of control exists. In this circumstance, the physician practice management entity must demonstrate that by virtue of a combination of its rights under the management agreement, by the powers possessed by its nominee shareholder, and by the provisions for corporate governance of the physician practice, it has control by meeting the control requirements.

>> Binding Arbitration Provisions

25-68 A provision for binding arbitration to settle disagreements between the physician practice management entity and the physician practice does not necessarily indicate that the physician practice management entity lacks exclusive authority over all decision making related to the items constituting the control requirements. For example, if binding arbitration is provided only to settle disputes over the meaning of contract terms and those decisions could not have the effect of overriding the physician practice management entity's exclusive decision-making authority over the matters identified in the control requirements, then the physician practice management entity may still comply with those control requirements. Conversely, if binding arbitration is provided to decide matters for which the physician practice management entity is required to have exclusive decision-making authority, then the physician practice management entity would not comply with those control requirements.

>> Powers Limited by Law

25-69 If federal, state, or corresponding non-U.S. laws limit the powers or discretion of any party over a particular decision, then the physician practice management entity's exclusive decision-making authority with respect to that matter is not, by definition, precluded. For example, antidumping statutes that prohibit physicians from refusing certain types of patients do not preclude the physician practice management entity from otherwise exerting exclusive authority of decision making over patient acceptance policies and procedures within the boundaries established by law.

>> Scope of Service Decisions

25-70 The physician practice management entity's exclusive decision-making authority over the physician practice's scope of services is not considered refuted if the range of medical disciplines in which the physician practice practices is set by mutual agreement of the physician practice management entity and the physician practice in the initial negotiation of the management agreement. Some examples of different medical disciplines are cardiology, neurology, obstetrics, ophthalmology, and radiology. Lack of physician practice management entity exclusive decision-making authority over initial and ongoing scope of service decisions within the physician practice's selected medical disciplines would, however, preclude a conclusion that the physician practice management entity controls the physician practice. Scope of service decisions within those practice disciplines are, for example, decisions about the range of cardiology services to provide, decisions about the range of neurology services to provide, and so forth.

>> Physician Cosigning Provisions

25-71 A provision requiring that the physician or physicians cosign a customer contract of the physician practice (that is, in addition to its execution on behalf of the physician practice by the physician practice management entity) does not preclude the physician practice management entity from having exclusive decision-making authority over the execution of contracts if the requirement for the physicians' signature is perfunctory. That requirement would generally be perfunctory if the physicians' execution of contracts creates no obligations for the physicians beyond the obligations that would exist if the physician practice management entity alone executed the contracts and if either of the following conditions is met:

a. The requirement for the physicians to execute a contract arises from state law or from a request by the payor on a particular contract.
b. The physicians have no effective discretion in executing contracts negotiated by the physician practice management entity (for example, the management agreement or the employment contract states that the physicians will not unreasonably withhold approval of contracts negotiated by the physician practice management entity).

25-72 The cosigning requirement is not considered perfunctory (and accordingly the first control requirement is not met) if any one of the following circumstances exists:

a. It arises out of authority given by the physician practice management entity to the physicians (other than to a physician who is the physician practice management entity's nominee shareholder of the physician practice and is acting in that capacity).

b. It gives rise to incremental obligations for the physician beyond the obligations that would exist if the physician practice management entity alone executed the contracts.
c. It gives the physicians discretion over which customer contracts will be executed by the physician practice management entity. This occurs, for example, if the physicians solely decide, or with the physician practice management entity they jointly decide, the boundaries for what constitutes an acceptable customer contract.

> Financial Interest

25-73 The following guidance applies to the evaluation of the financial interest requirement in paragraph 810-10-15-22(c) for identifying a physician practice management arrangement or similar contractual management arrangement as a controlling financial interest:

a. Nominee shareholder situation, presumption of financial interest—need to evaluate more than just the terms of the contractual management agreement
b. Nominee shareholder situation—need to evaluate more than just the terms of the contractual management agreement
c. Type and level of physician practice management entity participation
d. Level of participation
e. Substance versus form.

>> Nominee Shareholder Situation, Presumption of Financial Interest—Need to Evaluate More Than Just the Terms of the Contractual Management Agreement

25-74 If both of the following conditions exist, then the physician practice management entity is presumed to have a significant financial interest in the physician practice without reference to its current compliance with the financial interest requirements:

a. A majority of the outstanding voting equity instruments of the physician practice is owned by a nominee shareholder of the physician practice management entity, or owned by a combination of the physician practice management entity itself and its nominee shareholder.
b. It is determined that, after considering the rights of, and the physician practice management entity's (and its nominee's) obligations to, others (including any other physician practice shareholders and physicians employed by the physician practice), the physician practice management entity (or its nominee) has the power, at will and for no or only nominal consideration, to reset the terms of the physician practice management entity's financial interest in the physician practice.

This presumption is rebutted only if the physician practice management entity is precluded from resetting the terms of its financial interest in the physician practice to a basis that would meet the financial interest requirements, a circumstance that is unlikely to exist.

>> Nominee Shareholder Situation—Need to Evaluate More Than Just the Terms of the Contractual Management Agreement

25-75 If less than a majority of the outstanding voting equity instruments of the physician practice is owned by a nominee shareholder of the physician practice management entity, then no presumption of a significant financial interest exists. In this circumstance, the physician practice management entity must demonstrate that by virtue of a combination of its rights under the management agreement and by the powers possessed by its nominee shareholder it has a significant financial interest by meeting the financial interest requirements.

>> Type and Level of Physician Practice Management Entity Participation

25-76 A financial interest in a physician practice is the right to share in the change in the fair value of that physician practice. This right must be economically similar to the right a shareholder normally would possess. For purposes of the second financial interest requirement, that change in fair value is viewed as consisting of both of the following components:

a. The portion of the change that manifests itself as current operating results
b. The remainder, which is the portion of the change that manifests itself only upon sale or liquidation of the physician practice.

25-77 The second financial interest requirement requires that the physician practice management entity have rights to share in both components and that the amounts collectively derived constitute a significant portion of the total change in fair value. If the physician practice management entity's arrangement with the physician practice will end before the physician practice is sold or liquidated, the physician practice management entity would need to have the right to share in the change in the fair value of the physician practice that arose during the physician practice management entity's relationship with it in order to meet the requirement described in (b) in the preceding paragraph.

>> Level of Participation

25-78 The required significant level of financial interest of the physician practice management entity in the physician practice is intentionally not further prescribed. This is meant to convey that what is significant must be determined in the context of the facts and circumstances.

>> Substance versus Form

25-79 For purposes of determining compliance with the second financial interest requirement, the calculation of ongoing fees and the calculation of proceeds from sale are to be evaluated based on their substance as opposed to their form. Determining whether the requirement is met for a particular management fee structure will require the use of judgment.

25-80 Paragraph not used.

> Consideration Recorded in the Period Consideration Is Provided

25-81 Regardless of whether the consolidation status of the physician practice changes, consideration provided by the physician practice management entity to the physician practice in exchange for modifications to the physician practice management entity's arrangement with the physician practice shall be accounted for in the financial reporting period in which the modification is made, that is, the accounting for the consideration shall not be pushed back to a prior period. Furthermore, that consideration shall be recognized under generally accepted accounting principles (GAAP) according to the nature of the consideration.

> Physician Practice Management Entity Shareholder Fact Patterns

55-207 Situations involving non-nominee and nominee shareholder fact patterns are presented as additional information related to physician practice management entities.

>> Non-Nominee Shareholder

55-208 The following descriptions are included for background information purposes only. Not enough information is given in the examples to determine whether the physician practice management entity obtains an adequate controlling financial interest in the physician practice:

a. A physician practice management entity (Entity A) acquires all the outstanding stock of a physician practice (Entity B) directly from Entity B shareholders by issuing shares of Entity A voting common stock. Concurrent with the acquisition, the physicians who are the former owners of Entity B form a new professional corporation (Entity C), which enters into a long-term management agreement with Entity B. The physicians formerly of Entity B, who are now owners and employees of Entity C, enter into employment agreements with Entity C.
b. A physician practice management entity (Entity A) acquires all the outstanding stock of a physician practice (Entity B) directly from Entity B shareholders by issuing shares of Entity A voting common stock. Concurrent with the acquisition, the physicians and former owners of Entity B form a new professional corporation (Entity C) and enter into a long-term management agreement with Entity B. Although Entity A acquired the stock of Entity B, state law precludes contractual arrangements between physicians and hospitals and between physicians and health maintenance organizations from being held by a non-physician-owned practice (Entity B after the acquisition). Therefore, Entity B's patient contracts are transferred concurrent with the acquisition to Entity C. The physicians formerly of Entity B, who are now owners and employees of Entity C, enter into employment agreements with Entity C.
c. A physician practice management entity creates a wholly owned subsidiary (Entity A), which acquires all the net assets of a physician practice (Entity B) through the physician practice management entity's issuing some of its shares of voting common stock to Entity B. Concurrent with the transaction, Entity B enters into a long-term management agreement with Entity A. The ownership of Entity B remains the same; however, the physicians (that is, the owners of Entity B) enter into new employment agreements with Entity B.

>> Nominee Shareholder

55-209 The following descriptions are included for background information purposes only. Not enough information is given in the examples to determine whether the physician practice management entity obtains an adequate controlling financial interest in the physician practice:

a. At the direction of the physician practice management entity, a physician who will be the physician practice management entity's nominee shareholder incorporates a nominally capitalized new physician practice. In a subsequent exchange of shares, the physician practice management entity becomes the outright owner of the shares of the existing physician practice. The physician or physicians who were the former owners of the existing physician practice simultaneously sever their employment relationship with the existing physician practice and establish an employment relationship with the new physician practice. According to the terms of another simultaneously executed agreement, the physician who established the new physician practice becomes the physician practice management entity's nominee shareholder of that practice. A management agreement between the physician practice management entity and the new physician practice is also simultaneously executed.
b. The physician practice management entity issues its shares to the shareholders of the existing physician practice. Simultaneously, shares of the existing physician practice are delivered to a physician who is a nominee of the physician practice management entity, and a management agreement is executed between the physician practice management entity and the existing physician practice. By virtue of the terms of the management agreement that gives the rights to the residual equity of the existing physician practice to the physician practice management entity, the shares of the physician practice held by the nominee have only a nominal value. The physicians who previously owned the existing physician practice and who were employees of it execute new employment agreements with the now nominee-owned existing physician practice.

The Consolidation of Entities Controlled by Contract Subsections of Subtopic 810-10 provide guidance on when to consolidate a legal entity controlled by contract. Instead of applying the definition of a controlling financial interest under the VOE consolidation model (see chapter 5), this guidance has its own definition of a controlling interest in the context of a contractual relationship.

However, the entities controlled by contract Subsections apply only if the legal entity is not a VIE; therefore, an enterprise must first determine whether a legal entity is a VIE. In our experience it is rare to identify a legal entity that would be in the scope of these Subsections and is not a VIE. This is the case because if an entity is controlled by contract, it generally is a VIE – i.e. interests other than the equity-at-risk group have power over the entity's most significant activities (see section 4.3). As a result, we believe that the entities controlled by contract Subsections are applied only by enterprises that are exempt from the VIE consolidation model – e.g. NFPs. [810-10-15-14(b), 15-19, 15-22]

The guidance on entities controlled by contract is written in the context of physician practice management entities. However, the guidance can apply to any legal entity that is controlled by contract. Further, although the guidance has prescriptive elements, an enterprise must consider all the facts when evaluating the guidance. For example, relationships between the parties that may not be explicitly documented in the contractual agreements may be relevant. [810-10-15-19, 25-61]

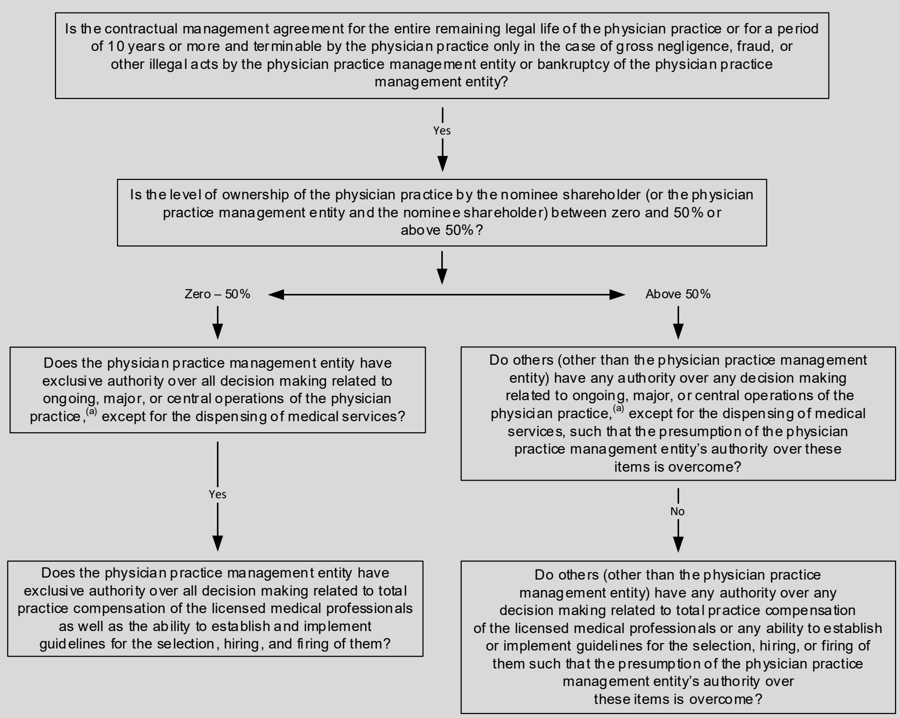
Subtopic 810-10 provides a useful decision tree to aid in determining whether to consolidate a legal entity controlled by contract.

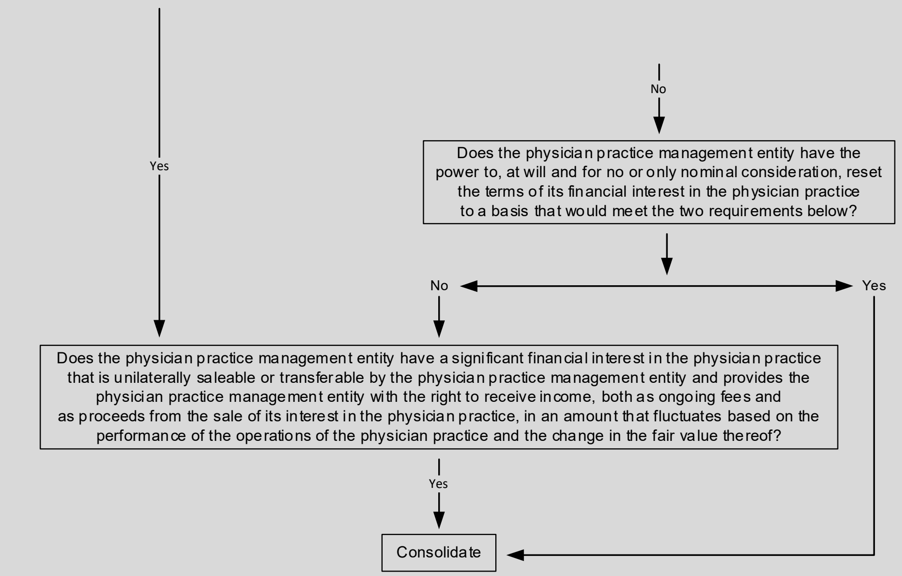
Excerpt from ASC 810-10

Consolidation of Entities Controlled by Contract

> Implementation Guidance

55-206 The decision tree that follows illustrates the analysis to determine whether a physician practice management entity shall consolidate a physician practice. The decision tree contains the term, control, and financial interest requirements, as those requirements are affected by the interpretive guidance that is presumptive in nature. The other interpretive guidance shall also be considered when working through the decision tree. If the answer to any question in the decision tree is other than as shown by the arrows, then the physician practice management entity should not consolidate the physician practice. Use of the decision tree is not a substitute for application of the Consolidation of Entities Controlled by Contract Subsections, including all the interpretive guidance. The following is an illustration of the analysis to determine whether a physician practice management entity should consolidate a physician practice.





(a) Paragraph 810-10-15-22(b)(1) describes the required extent of this decision-making authority.

9.3 Combined and parent-only financial statements

Excerpt from ASC 810-10

General

> Combined Financial Statements

45-10 If **combined financial statements** are prepared for a group of related entities, such as a group of commonly controlled entities, intra-entity transactions and profits or losses shall be eliminated, and **noncontrolling interests**, foreign operations, different fiscal periods, or income taxes shall be treated in the same manner as in consolidated financial statements.

> Parent-Entity Financial Statements

45-11 In some cases parent-entity financial statements may be needed, in addition to consolidated financial statements, to indicate adequately the position of bondholders and other creditors or preferred shareholders of the parent. Consolidating financial statements, in which one column is used for the parent and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information. However, consolidated financial statements are the general-purpose financial statements of a parent having one or more subsidiaries; thus, parent-entity financial statements are not a valid substitute for consolidated financial statements.

> Implementation Guidance

>> Combined Financial Statements

55-1B To justify the preparation of consolidated financial statements, the controlling financial interest shall rest directly or indirectly in one of the entities included in the consolidation. There are circumstances, however, in which combined financial statements (as distinguished from consolidated financial statements) of commonly controlled entities are likely to be more meaningful than their separate financial statements. For example, combined financial statements would be useful if one individual owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be used to present the financial position and results of operations of entities under common management.

An enterprise must present consolidated financial statements when it has a controlling financial interest in a legal entity. In contrast, combined financial statements are typically presented for entities under common control (see Question 3.8.230) when there is no controlling financial interest between the entities. [810-10-45-10, 55-1B]

Question 9.3.10

When is it appropriate to prepare combined financial statements?

Interpretive response: There are no specific requirements for when combined financial statements should be prepared. Combined financial statements are often prepared for commonly controlled entities when it is more meaningful than presenting the separate financial statements of each entity. Further, they are typically prepared for regulatory requirements.

Question 9.3.20

Must an enterprise first consider the consolidation requirements under Topic 810 before considering whether to prepare combined financial statements?

Interpretive response: Yes. An enterprise first considers the requirements for presenting consolidated financial statements before determining whether combined financial statements are appropriate. An enterprise must present consolidated financial statements when it holds a controlling financial interest in its subsidiaries.

Question 9.3.30

Are the procedures the same for preparing combined financial statements and consolidated financial statements?

Interpretive response: Yes. There is no difference in the procedures for preparing combined financial statements versus consolidated financial statements. An entity eliminates intra-entity profits and losses, and it accounts for items such as NCI, foreign operations, different fiscal periods, and income taxes in the same manner as it would in consolidated financial statements. [805-50-15-4]

9.4 NFP entities

9.4.10 Overview

Excerpt from ASC 810-10

General

> Entities

15-5 The application of this Topic by not-for-profit entities (NFPs) as defined in Topic 958 is subject to additional guidance in Subtopic 958-810.

Variable Interest Entities

> Entities

15-17 The following exceptions to the Variable Interest Entities Subsections apply to all legal entities in addition to the exceptions listed in paragraph 810-10-15-12:

a. **Not-for-profit entities** (NFPs) are not subject to the Variable Interest Entities Subsections, except that they may be related parties for purposes of applying paragraphs 810-10-25-42 through 25-44. In addition, if an NFP is used by business reporting entities in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entities Subsections, that NFP shall be subject to the guidance in the Variable Interest Entities Subsections.

Excerpt from ASC 958-810

05-1 This Subtopic provides guidance on the following:

a. Reporting relationships between a **not-for-profit entity** (NFP) and another NFP that potentially result in **consolidation**

b. Reporting relationships with special-purpose entity lessors (either for-profit entities or NFPs)
c. Reporting a noncontrolling interest in an acquiree
d. Reporting relationships between an NFP and a for-profit entity that is other than a **limited partnership** or similar **legal entity** (incremental guidance only).
e. Reporting relationships between an NFP that is a general partner or a limited partner and a for-profit limited partnership or similar legal entity.

05-2 An NFP may be related to one or more other NFPs in numerous ways, including any of the following:

a. Ownership
b. **Control**
c. **Economic interest**.

05-3 Because NFPs may exist in various legal forms, ownership of NFPs may be evidenced in various ways. Examples include:

a. Corporations issuing stock
b. Corporations issuing ownership certificates
c. Membership corporations issuing membership certificates
d. Joint ventures
e. Partnerships.

A parent corporation typically owns stock in a for-profit entity, whereas a sole corporate member holds (all) membership rights in an NFP.

05-4 The nature of the relationship between the entities determines the following:

a. Whether the financial statements of an NFP and those of another NFP should be consolidated
b. Whether the other NFP should be reported using a method similar to the equity method (see Subtopic 958-20)
c. The extent of the disclosure that should be required, if any.

> Overall Guidance

15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 958-10-15, with specific exceptions noted below.

> Other Considerations

15-3 This Subtopic does not provide guidance on the following subjects:

a. How to prepare consolidated financial statements, other than to provide guidance on the presentation of noncontrolling interests
b. Commonly controlled **not-for-profit entities** (NFPs) or **combined financial statements** of commonly controlled NFPs, which may be presented, in certain circumstances, in conformity with the guidance in paragraph 810-10-55-1B
c. Parent-entity-only or subsidiary-entity-only financial statements (see paragraph 810-10-45-11 if parent-entity financial statements are needed)
d. All the conceptual issues underlying the reporting of relationships not evidenced by ownership.

15-4 Additional guidance for reporting relationships between NFPs and for-profit entities resides in the following locations in the Codification:

a. An NFP with a controlling financial interest through direct or indirect ownership of a majority voting interest in a for-profit entity that is other than a **limited partnership** or similar **legal entity** shall apply the guidance in the General Subsections of Subtopic 810-10. However, in accordance with paragraph 810-10-15-17, NFPs are not subject to the Variable Interest Entities Subsections of that Subtopic.
b. An NFP that is a general partner or a limited partner of a for-profit limited partnership or a similar legal entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I. However, the guidance in those paragraphs does not apply to the following:
    1. A general partner or a limited partner that reports its partnership interest at fair value in accordance with (e)
    2. Entities in industries, such as the construction or extractive industries, in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).
c. An NFP that owns 50 percent or less of the voting stock in a for-profit entity shall apply the guidance in Subtopic 323-10 unless the investment is measured at fair value in accordance with applicable GAAP, including the guidance described in (e). If the NFP is unable to exercise significant influence, the NFP shall apply the guidance for equity securities in Topic 321.
d. An NFP with a more than minor noncontrolling interest in a for-profit real estate partnership, limited liability company, or similar legal entity shall report its noncontrolling interests in such entities using the equity method in accordance with the guidance in Subtopic 970-323 unless that interest is reported at fair value in accordance with applicable GAAP, including the guidance described in (e). An NFP shall apply the guidance in paragraph 970-810-25-1 to determine whether its interests in a general partnership are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I to determine whether its interests in a for-profit limited partnership, limited liability company, or similar legal entity are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraph 323-30-35-3 to determine whether a limited liability company should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether noncontrolling interests in a limited liability company or a similar legal entity should be accounted for in accordance with Subtopic 970-323 or Subtopic 323-10.
e. An NFP that is not within the scope of Topic 954 on health care entities may elect to report the investments described in (b) through (d) and paragraph 958-325-15-2 at fair value, with changes in fair value reported in the statement of activities, provided that all such investments are measured at fair value.

When the FASB adopted the VIE consolidation model it provided a scope exception for NFP entities. The legacy guidance applied only to business reporting entities, which the FASB determined did not encompass NFP entities. Therefore, unless an enterprise is using an NFP to prevent or circumvent the VIE consolidation model, that model is not applied to NFP entities (see section 2.3.20). Instead, Subtopic 958-810 generally applies to NFPs as addressed in this section. Subtopic 954-810 (health care entities) provides incremental presentation and disclosure guidance for NFPs in its scope. [810-10-15-17]

Question 9.4.10

What reporting relationships are covered under Subtopic 958-810, and how does the nature of the relationship impact consolidation?

Interpretive response: Subtopic 958-810 provides guidance on the following: [958-810-05-1]

— relationships between two NFPs;
— relationships with SPE lessors that are either for-profit entities or NFPs;
— reporting NCIs in an acquiree;
— relationships between an NFP and a for-profit entity other than a limited partnership or similar legal entity; and
— relationships between an NFP (that is a GP or an LP) and a for-profit limited partnership or similar legal entity.

The nature of these relationships impacts: [958-810-05-4]

— whether the financial statements of an NFP should be consolidated with another entity under the VOE consolidation model;
— whether an NFP should be reported using the equity method; and
— the extent of any required disclosures.

Subtopic 954-810 (health care entities) provides incremental presentation and disclosure guidance for NFPs in its scope.

9.4.20 Recognition

Excerpt from ASC 958-810

25-1 A relationship with another **not-for-profit entity** (NFP) can take any one of the following forms, which determines the appropriate reporting:

a. A controlling financial interest through direct or indirect ownership of a majority voting interest or sole corporate membership in the other NFP (see the following paragraph)
b. Subparagraph not used
c. **Control** of a related but separate NFP through a majority voting interest in the board of that NFP by means other than ownership or sole corporate

membership and an **economic interest** in that other NFP (see paragraph 958-810-25-3)

d. An economic interest in the other NFP combined with control through means other than those listed in (a) through (c) (see paragraph 958-810-25-4)
e. Either an economic interest in the other NFP or control of the other NFP, but not both (see paragraph 958-810-25-5).

> Controlling Financial Interest via Majority Voting Interest or Sole Corporate Membership

25-2 An NFP with a controlling financial interest in another NFP through direct or indirect ownership of a majority voting interest or sole corporate membership in that other NFP shall consolidate that other NFP, unless control does not rest with the majority owner or sole corporate member (for example, if the subsidiary is in legal reorganization or bankruptcy), in which case **consolidation** is prohibited, as discussed in paragraph 810-10-15-10. Sole corporate membership in an NFP, like ownership of a majority voting interest in a for-profit entity, shall be considered a controlling financial interest, unless control does not rest with the sole corporate member (for instance, if the other [membership] entity is in bankruptcy or if other legal or contractual limitations are so severe that control does not rest with the sole corporate member).

25-2A In some situations, certain actions require approval by a supermajority vote of the board. Such voting requirements might overcome the presumption of control by the owner or holder of a majority voting interest. For related implementation guidance, see paragraph 958-810-55-4A.

> Majority Voting Interest in the Board

25-3 In the case of control of a related but separate NFP through a majority voting interest in the board of the other NFP by means other than ownership or sole corporate membership and an economic interest in that other NFP, consolidation is required, unless control does not rest with the holder of the majority voting interest, in which case consolidation is prohibited. An NFP has a majority voting interest in the board of another entity if it has the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board (that is, including any vacant board positions). Those individuals are not limited to the NFP's own board members, employees, or officers. For implementation guidance on a majority voting interest in the board of another entity, see paragraph 958-810-55-5.

> Implementation Guidance

>> Flowcharts

>>> Majority Voting Interest in the Board of Another Entity

55-4A This paragraph provides implementation guidance on the application of paragraph 958-810-25-2A to situations in which certain actions require approval by a supermajority vote of the board. That paragraph states that such voting requirements might overcome the presumption of control by the owner or holder of a majority voting interest. An NFP shall exercise judgment in evaluating such situations. If supermajority voting requirements exist—for example, a specified supermajority of the board is needed to approve fundamental actions such as amending the articles of incorporation or dissolving the entity, an NFP shall consider whether those voting requirements have little or no effect on the ability to control the other entity's operations or assets or, alternatively, whether those voting requirements are so restrictive as to call into question whether control rests with the holder of the majority voting interest. The guidance in paragraphs 810-10-25-2 through 25-14 may be helpful in considering whether the inability of the majority voting interest to unilaterally approve certain actions due to supermajority voting requirements is substantial enough to overcome the presumption of control.

55-5 A majority voting interest in the board of another entity, as referred to in paragraph 958-810-25-3, is illustrated by the following example. Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of Entity B if Entity A has the ability to appoint three or more of Entity B's board members. If three of Entity A's board members, employees, or officers serve on the board of Entity B but Entity A does not have the ability to require that those members serve on the Entity B board, Entity A does not have a majority voting interest in the board of Entity B.

> Control by Other Means

25-4 Control of a related but separate NFP in which the reporting entity has an economic interest may take forms other than majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required. Consolidation is encouraged if both of the following criteria are met:

a. The reporting entity controls a separate NFP in which it has an economic interest and that control is not control through either of the following means:
    1. A controlling financial interest in the other NFP through direct or indirect ownership of a majority voting interest
    2. A majority voting interest in the board of the other NFP.
b. Consolidation would be meaningful.

> Control or an Economic Interest, but Not Both

25-5 The existence of control or an economic interest, but not both, precludes consolidation.

> Implementation Guidance

>> Flowcharts

>>> Economic Interests

55-6 The following are examples of **economic interests**:

a. Other entities solicit funds in the name of and with the expressed or implied approval of the NFP, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the NFP or used at its discretion or direction.
b. An NFP transfers significant resources to another entity whose resources are held for the benefit of the NFP.
c. An NFP assigns certain significant functions to another entity.

d. An NFP provides or is committed to provide funds for another entity or guarantees significant debt of another entity.
e. An NFP has a right to or a responsibility for the operating results of another entity. Or upon dissolution, an NFP is entitled to the net assets, or is responsible for any deficit, of another entity.

> Less than a Complete Interest in the Subsidiary NFP

25-6 An interest by an NFP in another NFP may be less than a complete interest. For example, an NFP may appoint 80 percent of the board of the other NFP. For NFPs other than those within the scope of Topic 954, if the conditions for consolidation in paragraphs 958-810-25-2, 958-810-25-3, or 958-810-25-4 are met, the basis of that consolidation would not reflect a **noncontrolling interest** for the portion of the board that the reporting entity does not control, because there is no ownership interest other than the interest of the reporting entity.

> Revenue Sharing and Other Agreements

25-7 Some NFPs may enter into agreements with other entities, such as sharing revenue, resulting in liabilities to those other entities. In such circumstances, those liabilities shall be reported. If NFPs agree to share revenue from fundraising campaigns, the appropriate accounting depends on the relationship between the NFPs. See Subtopic 958-20 for agreements in which an NFP agrees to raise or hold **contributions** for a financially interrelated entity. See paragraph 958-605-25-24 for agreements in which an NFP agrees to raise or hold contributions for another NFP as its **agent**.

> Special-Purpose-Entity Lessors

25-8 Notwithstanding the guidance in this Subtopic, an NFP that is engaged in leasing transactions with a special-purpose-entity (SPE) lessor shall consider whether it should consolidate such lessor. Specifically, such an NFP shall consolidate an SPE lessor if all of the following conditions exist:

a. Substantially all of the activities of the SPE involve assets that are to be leased to a single lessee.
b. The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through means such as any of the following:
    1. The lease agreement
    2. A residual value guarantee through, for example, the assumption of first-dollar-of-loss provisions
    3. A guarantee of the SPE's debt
    4. An option granting the lessee a right to do either of the following:
        i. To purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise
        ii. To receive any of the lessor's sales proceeds in excess of a stipulated amount.
c. The owner (or owners) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire **lease term**. This criterion shall be considered met if the majority

owner (or owners) of the lessor is not an independent third party, regardless of the level of capital investment.

25-9 To satisfy the at-risk requirement in item (c) in the preceding paragraph, an initial substantive residual equity capital investment shall meet all of the following conditions:

a. It represents an equity interest in legal form.
b. It is subordinate to all debt interests.
c. It represents the residual equity interest during the entire lease term.

25-10 If all of the conditions in paragraph 958-810-25-8 exist, the assets, liabilities, results of operations, and cash flows of the SPE shall be consolidated in the lessee's financial statements. This conclusion shall be applied to SPEs that are established for both the construction and subsequent lease of an asset for which the lease would meet all of the conditions in paragraph 958-810-25-8. In those cases, the consolidation by the lessee shall begin at **lease inception** rather than the beginning of the lease term. For related implementation guidance, see paragraphs 958-810-55-7 through 55-16.

> Implementation Guidance

>> Special-Purpose-Entity Lessors

55-7 For an NFP that is engaged in leasing transactions with a special-purpose-entity (SPE) lessor, this implementation guidance addresses the following matters:

a. Multiple properties within a single SPE lessor
b. Multitiered SPE structures
c. Payments to equity owners of an SPE during the **lease term**
d. Fees paid to owners of record of an SPE
e. Source of initial minimum equity investment
f. Payment to owners of record of an SPE before the lease term
g Subparagraph superseded by Accounting Standards Update No. 2016-02

>>> Multiple Properties Within a Single SPE Lessor

55-8 This implementation guidance addresses the application of paragraph 958-810-25-8(a) to a transaction involving all of the following characteristics:

a. An SPE is formed to acquire two separate properties that are to be leased to two unrelated lessees.
b. The two asset acquisitions are financed with the proceeds from two nonrecourse borrowings that do not contain cross-collateral provisions; that is, in the event of default, each borrowing is collateralized only by a pledge of the respective assets leased to a single lessee and an assignment of the respective lease payments under the related lease.
c. The SPE has no assets other than the leased properties and the related leases.

55-9 The use of nonrecourse debt with no cross-collateral provisions effectively segregates the cash flows and assets associated with the two leases and, therefore, in substance, creates two SPEs. For purposes of applying the provisions of paragraph 958-810-25-8, each lessee would be considered to have satisfied the condition in paragraph 958-810-25-8(a). For either lessee to be in a position of not satisfying that condition, the assets of the SPE (subject to the two leases) would need to be commingled such that, in .the event of default, both lenders to the SPE would have equal rights (that is, pari passu) to the cash flows and assets related to both leases of the SPE. In this regard, the amounts of the cash flows from each lease and the fair values of the individual assets subject to the leases must represent more than a minor amount (that is, more than 10 percent) of the aggregate cash flows from all leases and the aggregate fair value of all assets of the SPE, respectively.

>>> Multitiered SPE Structures

55-10 This implementation guidance addresses the level at which an entity should apply the conditions in paragraph 958-810-25-8 to a transaction having all of the following characteristics:

a. Sponsor forms an SPE, SPE A.
b. SPE A acquires property with the proceeds from nonrecourse debt and leases the property to Lessee A.
c. SPE A has no other activities and the terms of the lease satisfy the condition in paragraph 958-810-25-8(b), which discusses the residual risks and rewards associated with the leased assets and related debt.
d. The sponsor owns 100 percent of SPE A's voting common stock.
e. The sponsor contributes the common stock of SPE A to capitalize another SPE (SPE B) that is formed to own and lease assets to Lessee B.
f. The other assets of SPE B are financed entirely with nonrecourse debt and are subject to a lease, the terms of which also satisfy the condition in paragraph 958-810-25-8(b).

Thus, SPE B, which is wholly owned by the sponsor, becomes the parent of SPE A.

55-11 Consistent with the implementation guidance in paragraph 958-810-55-8 that addresses multiple properties within a single SPE, the conditions set forth in paragraph 958-810-25-8 shall be applied at the lowest level at which the parties to a transaction create an isolated entity, whether by contract or otherwise. Therefore, in the situation described in the preceding paragraph, the test for compliance with the condition in paragraph 958-810-25-8(a) should be applied to the parent-only financial statements of SPE B.

55-12 In the transaction described in paragraph 958-810-55-10, assume the assets of SPE B will include the common stock of SPE A and the assets leased to Lessee B. Ownership of the stock of another SPE that is engaged in leasing property would not constitute an activity contemplated by the condition in paragraph 958-810-25-8(a). Accordingly, in this situation, the lessee shall consider that condition to be satisfied in evaluating the activities of SPE B. In addition, the sponsor's contribution of the stock of SPE A to capitalize SPE B shall not be considered an initial substantive residual equity capital investment, as contemplated by the condition in paragraph 958-810-25-8(c), because a sponsor's investment shall not be used to capitalize more than one SPE for purposes of applying that condition.

>>> Payments to Equity Owners of an SPE during the Lease Term

55-13 The characterization of any payments made by the SPE-lessor to its owners of record shall be based on the SPE's GAAP basis financial statements. That is, distributions of the SPE-lessor's GAAP basis change in net assets shall be considered a return on equity capital, but any distribution in excess of previously undistributed GAAP change in net assets shall be considered a return of equity capital, which would reduce the amount of the equity capital investment that is at risk. If the amount of the equity capital investment is reduced below the minimum amount required as a result of a distribution in excess of previously undistributed GAAP change in net assets, the owner of record would have to make an additional investment to continue to avoid the condition in paragraph 958-810-25-8(c). An owner of record would not be required to make an additional equity capital investment if residual equity capital is reduced below the minimum amount required because of losses recorded by the SPE in accordance with generally accepted accounting principles.

>>> Fees Paid to Owners of Record of an SPE

55-14 Paragraph 842-10-30-5(e) states that, for a lessee, lease payments include fees that are paid by the lessee to the owners of the special-purpose entity for structuring the lease transaction. Paragraph 842-10-30-5(e) states that such fees shall be included as part of lease payments (but shall not be included in the fair value of the underlying asset) for purposes of applying the criterion in paragraph 842-10-25-2(d). With respect to the SPE and the application of the guidance in paragraph 958-810-25-8, the fees paid by the lessee to the owners of the SPE shall be considered a return of the owners' initial equity capital investment. To the extent that the fees reduce the equity capital investment below the minimum amount required, the owners of record would not be considered to have a substantive residual equity capital investment that is at risk during the entire term of the lease.

>>> Source of Initial Minimum Equity Investment

55-15 If the source of the funds used to make the initial minimum equity investment in an SPE lessor is financed with nonrecourse debt that is collateralized by a pledge of the investment, the investment shall not meet the at-risk requirement in paragraph 958-810-25-8(c). Similarly, that at-risk requirement shall not be met if the owners purchased residual insurance or obtained a residual guarantee in an amount that would ensure recovery of their equity investment. If the initial minimum equity investment is financed with recourse debt from a party not related to the lessee, the owners (borrowers) shall have other assets at risk to support the borrowing to avoid the condition in paragraph 958-810-25-8(c). Thus, if the loans were full recourse loans and if the fair value of the residual equity investment serves as collateral for the debt, the lessor-owner shall be considered at risk to the extent that the owners of record are liable for any decline in the fair value of the residual interest and have, and are expected to continue to have during the term of the lease, other significant assets, in addition to and of a value that exceeds their equity investment, that are at risk.

>>> Payment to Owners of Record of an SPE before the Lease Term

55-16 In some build-to-suit lease transactions involving SPEs, the lease or related construction agreement provides that the SPE will construct, or cause to be constructed, the property that is to be leased. The terms of the construction or lease agreements provide that payments are to be made by the SPE to the owners of record during the construction period, which, in some cases, may be several years. Such payments generally are made to provide the owners of record with a cash yield on their equity capital investments.

Payments made by the SPE to the owners of record of the SPE during the construction period shall be deemed to be a return of their initial equity capital investment as opposed to a return on their equity capital investment. To the extent that those payments reduce the equity capital investment below the minimum amount required under paragraph 958-810-25-8, the owners of record of the SPE shall not be considered to have made an initial substantive residual equity capital investment that is at risk during the entire lease term.

> Control of Limited Partnerships and Similar Legal Entities

25-11 The guidance in this paragraph and paragraphs 958-810-25-12 through 25-29 and 958-810-55-16A through 55-16I addresses the potential **consolidation** of **limited partnerships** and similar **legal entities**. A similar legal entity is an entity (such as a limited liability company) that has governing provisions that are the functional equivalent of a limited partnership. In those entities, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner. Throughout those paragraphs, any reference to a limited partnership includes limited partnerships and similar legal entities.

>> General Partners or Limited Partners That Control a Limited Partnership

25-12 The general partners in a **limited partnership** are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.

25-13 If a limited partnership has multiple general partners, the determination of which, if any, general partner within the group controls and, therefore, shall consolidate the limited partnership is based on an analysis of the relevant facts and circumstances. In situations involving multiple general partners, entities under common control are considered to be a single general partner for purposes of applying the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I.

25-14 The assessment of whether the rights of the limited partners overcome the presumption of control by the general partners is a matter of judgment that depends on facts and circumstances. The general partners do not control the limited partnership if the limited partners have either of the following:

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

25-15 If the limited partners have substantive kick-out rights or substantive participating rights, the presumption of control by the general partners is overcome and each of the general partners shall account for its investment in the limited partnership using the equity method of accounting. Topic 323 provides guidance on the equity method of accounting.

25-16 If one limited partner directly or indirectly owns more than 50 percent of a limited partnership’s kick-out rights through voting interests, then that limited partner shall be deemed to have a controlling financial interest in the limited partnership and shall consolidate the limited partnership. However, if noncontrolling limited partners have substantive participating rights, then the limited partner with a majority of kick-out rights through voting interests does not have a controlling financial interest.

25-17 The guidance in paragraphs 958-810-25-19 through 25-29 shall be considered in evaluating whether rights held by the limited partners overcome the presumption of control by the general partners.

25-18 Limited partners' rights and their effect on whether the presumption of control by the general partners is overcome and on whether one limited partner has a controlling financial interest in a limited partnership shall be assessed when an investor first becomes a partner and shall be reassessed at each reporting period thereafter for which financial statements of the partner(s) are prepared.

>>> Substantive Kick-Out Rights

25-19 All relevant facts and circumstances shall be considered in determining whether kick-out rights are substantive. Substantive kick-out rights must have both of the following characteristics:

a. The kick-out rights can be exercised by a single limited partner or a vote of a simple majority (see Example 2 in paragraph 958-810-55-26) or a lower percentage of the limited partners' voting interests held by parties other than the general partners, 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 represents at least a simple majority of the limited partners' voting interests that cannot remove the general partners (see Example 2, Case D in paragraph 958-810-55-30). 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 Topic 850, may be acting with the limited partner in exercising their kick-out rights.

b. The limited partners holding the kick-out rights must have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to, the following:

    1. Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
    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 (liquidation) 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.

25-20 For purposes of applying the guidance in paragraph 958-810-25-19, the limited partners' unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership shall not be deemed a kick-out right. The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners does not have to be contractual for a withdrawal right to be considered as a potential kick-out right.

>>> Substantive Participating Rights

25-21 Participating rights are different from **protective rights**. Limited partners' rights that are only protective in nature do not overcome the presumption that the general partners control the limited partnership. Limited partners' rights, individually or in the aggregate, that provide the limited partners with the right to effectively participate in certain significant financial and operating decisions that are made in the ordinary course of the limited partnership's business, while being protective of the limited partners' investment, overcome the presumption that the general partners control the limited partnership.

25-22 Limited partners' rights (whether granted by contract or by law) that allow limited partners to effectively participate in the following actions of the limited partnership shall be considered substantive participating rights and, therefore, overcome the presumption that the general partners control the limited partnership:

a. Selecting, terminating, and setting the compensation of management responsible for implementing the limited partnership's policies and procedures
b. Establishing operating and capital decisions of the limited partnership, including budgets, in the **ordinary course of business**

These rights are considered illustrative of substantive participating rights but are not necessarily an all-inclusive list.

25-23 The rights described in paragraph 958-810-25-22 are participating rights because, in the aggregate, they allow the limited partners to effectively participate in certain significant financial and operating decisions that occur as part of the ordinary course of the limited partnership's business and are significant factors in directing and carrying out the activities of the limited partnership.

25-24 Rights held by the limited partners to remove the general partners from the partnership shall be evaluated as kick-out rights in accordance with paragraph 958-810-25-19. Rights of the limited partners to participate in the termination of management (for example, management is outsourced to a party other than the general partner) or the individual members of management of the limited partnership may be substantive participating rights.

25-25 Individual rights, such as the right to veto the termination of management responsible for implementing the limited partnership's policies and procedures (if management is outsourced—via contract with a third party—by the general partners), shall be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves. The likelihood that the veto right will be exercised by the limited partners shall not be considered when assessing whether a limited partner's right is a substantive participating right.

25-26 Limited partners' rights that appear to be participating rights but that by themselves are not substantive do not overcome the presumption of control by the general partners in the limited partnership.

>>>> Factors to Consider in Determining Whether Limited Partners' Participating Rights Are Substantive

25-27 The following factors shall be considered in evaluating whether limited partners' participating rights are substantive such that the rights provide for effective participation in certain significant decisions related to the limited partnership's ordinary course of business:

a. The limited partnership agreement shall be considered to determine at what level decisions are made (that is, by the general partners or by the limited partnership as a whole). Also, the rights at each level shall be considered. In all situations, any matters that can be put to a vote of the limited partnership shall be considered to determine whether the limited partners, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a vote of the limited partnership. Determining whether matters that can be put to a vote of the limited partners, or the vote of the limited partnership as a whole, are substantive shall be based on a consideration of all relevant facts and circumstances.
b. Relationships between the general partners and the limited partners (other than investment in the common limited partnership) that are of a related-party nature, as defined in Topic 850, shall be considered in determining whether the participating rights of the limited partners are substantive. For example, if the limited partner in a limited partnership is a member of the immediate family of the general partners of the limited partnership, then the rights of the limited partner likely would not overcome the presumption of control by the general partners.
c. Certain limited partners' rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the limited partnership. Limited partners' rights related to items that are not considered significant for directing and carrying out the activities of the limited partnership's ordinary course of business are not substantive participating rights and do not overcome the presumption of control by the general partners. Examples of such limited partners' rights include the following decisions:
    1. Location of the limited partnership's headquarters
    2. Name of the limited partnership
    3. Selection of auditors
    4. Selection of accounting principles for purposes of separate reporting of the limited partnership's operations.

d. Certain limited partners' rights may provide for the limited partners to participate in certain significant financial and operating decisions that are made in the ordinary course of business; however, the existence of such limited partners' rights shall not overcome the presumption that the general partners have control if it is remote that the event or transaction that requires the limited partners' approval will occur.
e. General partners who have a contractual right to buy out the interest of the limited partners in the limited partnership for fair value or less shall consider the feasibility of exercising that contractual right when determining if the participating rights of the limited partners are substantive. If such a buyout is prudent, feasible, and substantially within the control of the general partners, the general partners' contractual right to buy out the limited partners demonstrates that the participating right of the limited partners is not a substantive right. The existence of such call options, for purposes of this Subtopic, negates the participating rights of the limited partners to approve or veto an action of the general partners rather than creates an additional ownership interest for the general partners. It would not be prudent, feasible, and substantially within the control of the general partners to buy out the limited partners if, for example, either of the following conditions exists:
    1. The limited partners control technology that is critical to the limited partnership.
    2. The limited partners are the principal source of funding for the limited partnership.

>>> Protective Rights

25-28 Limited partners' rights (whether granted by contract or by law) that allow the limited partners to block the following limited partnership’s actions are considered protective rights and do not overcome the presumption of control by the general partners:

a. Amendments to the limited partnership agreement
b. Pricing on transactions between the general partners and the limited partnership and related self-dealing transactions
c. Liquidation of the limited partnership in the context of Topic 852 on reorganizations initiated by the general partners or a decision to cause the limited partnership to enter bankruptcy or other receivership
d. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (Limited partners' rights relating to acquisitions and dispositions that are expected to be made in the ordinary course of the limited partnership's business are participating rights. Determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances.)
e. Issuance or repurchase of limited partnership interests.

These are illustrative of some, but not all, of the protective rights that often are provided to limited partners.

> Implementation Guidance

>> Assessing Limited Partners' Protective Rights and Substantive Participating Rights

55-16A The following implementation guidance is intended to facilitate the understanding of how to assess whether the rights of the limited partners should be considered **protective rights** or **participating rights** and, if participating rights, whether the rights are substantive. Although this guidance illustrates possible assessments of individual limited partners' rights, the evaluation of limited partners' rights should consider all of the factors identified in paragraph 958-810-25-27 to determine whether the limited partners' rights, individually or in the aggregate, provide for the limited partners to effectively participate in significant decisions that would be expected to be made in the **ordinary course of business**.

>>> Approval of Acquisitions and Dispositions

55-16B The rights of the limited partners relating to the approval of acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business may be substantive participating rights. Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of business usually are protective and do not overcome the presumption of control by the general partners in the limited partnership. Determining whether the right to approve the acquisition or disposition of assets is in the ordinary course of business should be based on an evaluation of the relevant facts and circumstances. In addition, if approval by the limited partners is necessary to incur additional indebtedness to finance an acquisition that is not in the limited partnership's ordinary course of business, then the approval by the limited partners is considered a protective right.

>>> Approval for Incurring Additional Indebtedness

55-16C Existing facts and circumstances should be considered in assessing whether the rights of the limited partners relating to a limited partnership incurring additional indebtedness are protective or participating rights. For example, if it is reasonably possible or probable that the limited partnership will need to incur the level of borrowing that requires limited partner approval in its ordinary course of business, the rights of the limited partners are viewed as substantive participating rights.

>>> Rights Relating to Dividends and Other Distributions

55-16D The rights of the limited partners relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions are protective rights.

>>> Rights Relating to Partnership-Specific Action

55-16E The rights of the limited partners relating to a limited partnership's specific action (for example, to lease property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if the limited partnership had the ability to purchase, rather than lease, the property without requiring the approval of the limited partners, then the rights of the limited partners to block the limited partnership from entering into a **lease** are not substantive participating rights.

>>> Rights Relating to Negotiation of Collective Bargaining Agreements

55-16F The rights of the limited partners relating to a limited partnership's negotiation of collective-bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if a limited partnership does not have a collective-bargaining agreement with a union or if the union does not represent a substantial portion of the limited partnership's work force, then the rights of the limited partners to approve or veto a new or broader collective-bargaining agreement are not substantive participating rights.

>>> Rights to Block Action of General Partner

55-16G Provisions that govern what will occur if the limited partners block the action of the general partners need to be considered to determine whether the rights of the limited partners to block have substance. For example, if both of the following circumstances exist, then the rights of the limited partners to block the approval of the operating and capital budgets do not allow the limited partners to effectively participate and, thus, are not substantive participating rights:

a. The limited partnership agreement provides that if the limited partners block the approval of operating and capital budgets, then the budgets simply default to last year's budgets adjusted for inflation.
b. The limited partnership operates in a mature business for which year-to-year operating and capital budgets would not be expected to vary significantly.

>>> Rights Relating to the Initiation of a Lawsuit

55-16H Limited partners' rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances. For example, if lawsuits are a part of, or are expected to be a part of, the limited partnership's ordinary course of business, as is the case for some insurance entities, then the limited partners' rights may be considered substantive participating rights.

>>> Right to Veto Annual Operating and Capital Budgets

55-16I The limited partners have the right to veto the annual operating and capital budgets for the first X years of the limited partnership. Based on the facts and circumstances, during the first X years of the limited partnership, this right may be a substantive participating right. However, following Year X there is a significant change in the exercisability of the limited partners' right (for example, the veto right terminates). As of the beginning of the period following Year X the presumption that the general partners control the partnership no longer is overcome because that right no longer exists.

As discussed in Question 9.4.10, an NFP applies Subtopic 958-810 to determine whether it consolidate the following legal entities:

- another NFP;
- an SPE lessor that is either a for-profit entity or an NFP; and
- a for-profit entity.

The guidance in Subtopic 958-810 provides specific factors and situations to consider when determining if consolidation is required or permitted.

Question 9.4.20

What are the forms a relationship can take with another NFP, and what are the corresponding reporting implications?

Interpretive response: A relationship between NFPs can take one of the following forms, and the relationship will have the following impact when considering consolidation:

Relationship	Consolidate?
A controlling financial interest through direct or indirect ownership of a majority voting interest or sole corporate membership in the other NFP. [958-810-25-1(a)]	Yes – unless control does not rest with the majority owner or sole corporate member (e.g. if the subsidiary is in legal reorganization or bankruptcy). [958-810-25-2]
Control of a related but separate NFP through a majority voting interest in the board of that NFP by means other than ownership or sole corporate membership and an economic interest in that other NFP. [958-810-25-1(c)]	Yes – unless control does not rest with the holder of the majority voting interest. A majority voting interest exists if an NFP has the ability to appoint individuals to the board of another entity that make up the majority of votes of the board. [958-810-25-3]
An economic interest in the other NFP combined with control through means other than those listed above. [958-810-25-1(d)]	It depends. An NFP is permitted (but not required) to consolidate if both control by other means and an economic interest are present. Control may exist through a contract or affiliate agreement instead of through ownership or control of the board. [958-810-25-4]
Either an economic interest in the other NFP or control of the other NFP, but not both. [958-810-25-1(e)]	No. The existence of both control and an economic interest must be present. [958-810-25-5]

Question 9.4.30

How should the guidance be applied to a relationship with another NFP?

Interpretive response: Paragraph 958-810-55-3 summarizes the guidance in the flowing flowchart when determining whether to consolidate based on a relationship with another NFP.

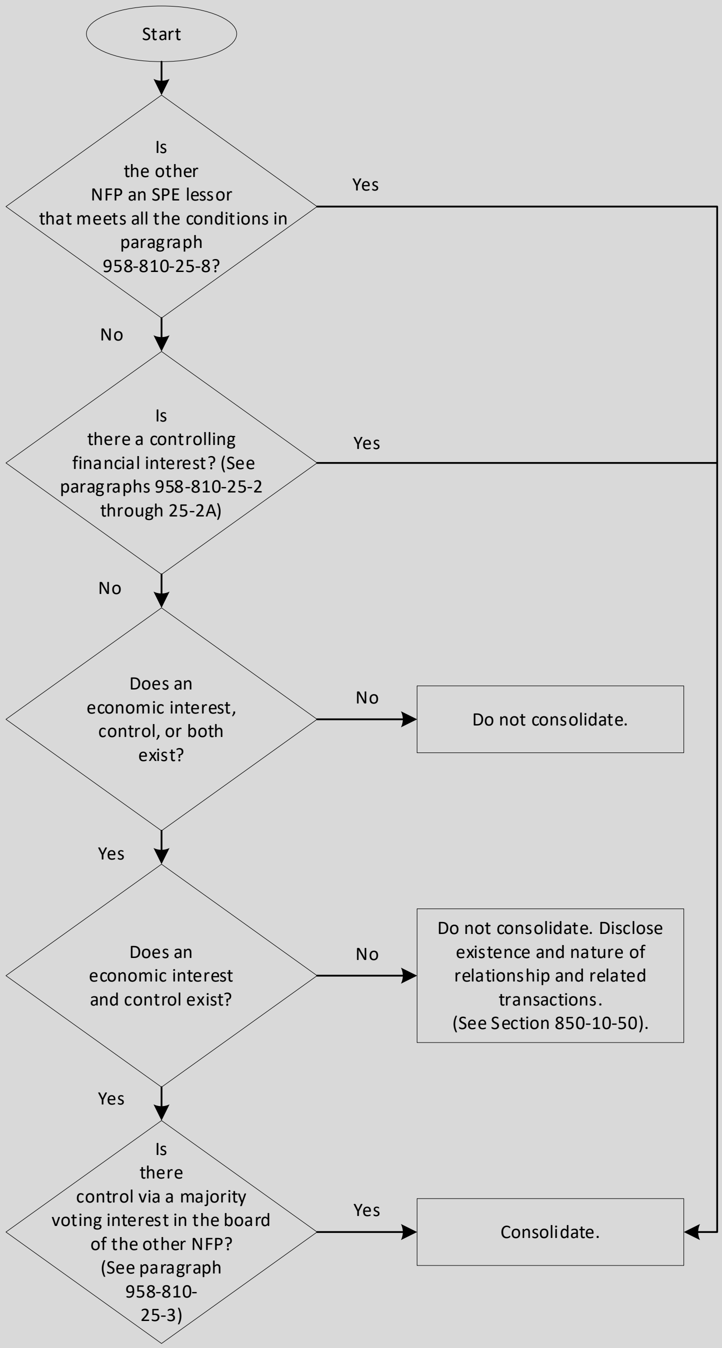
Excerpt from ASC 958-810

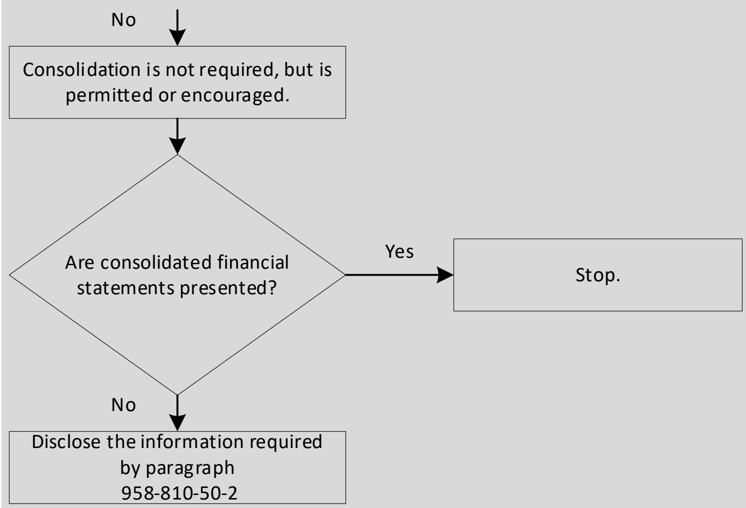
> Implementation Guidance

>> Flowcharts

>>> Relationship with Another NFP

55-3 The following flowchart summarizes the guidance in Section 958-810-25.





Question 9.4.40

How should the guidance be applied to a relationship with a for-profit entity?

Interpretive response: Paragraph 958-810-55-4 summarizes the guidance in the following flowchart when determining whether to consolidate based on a relationship with a for-profit entity.

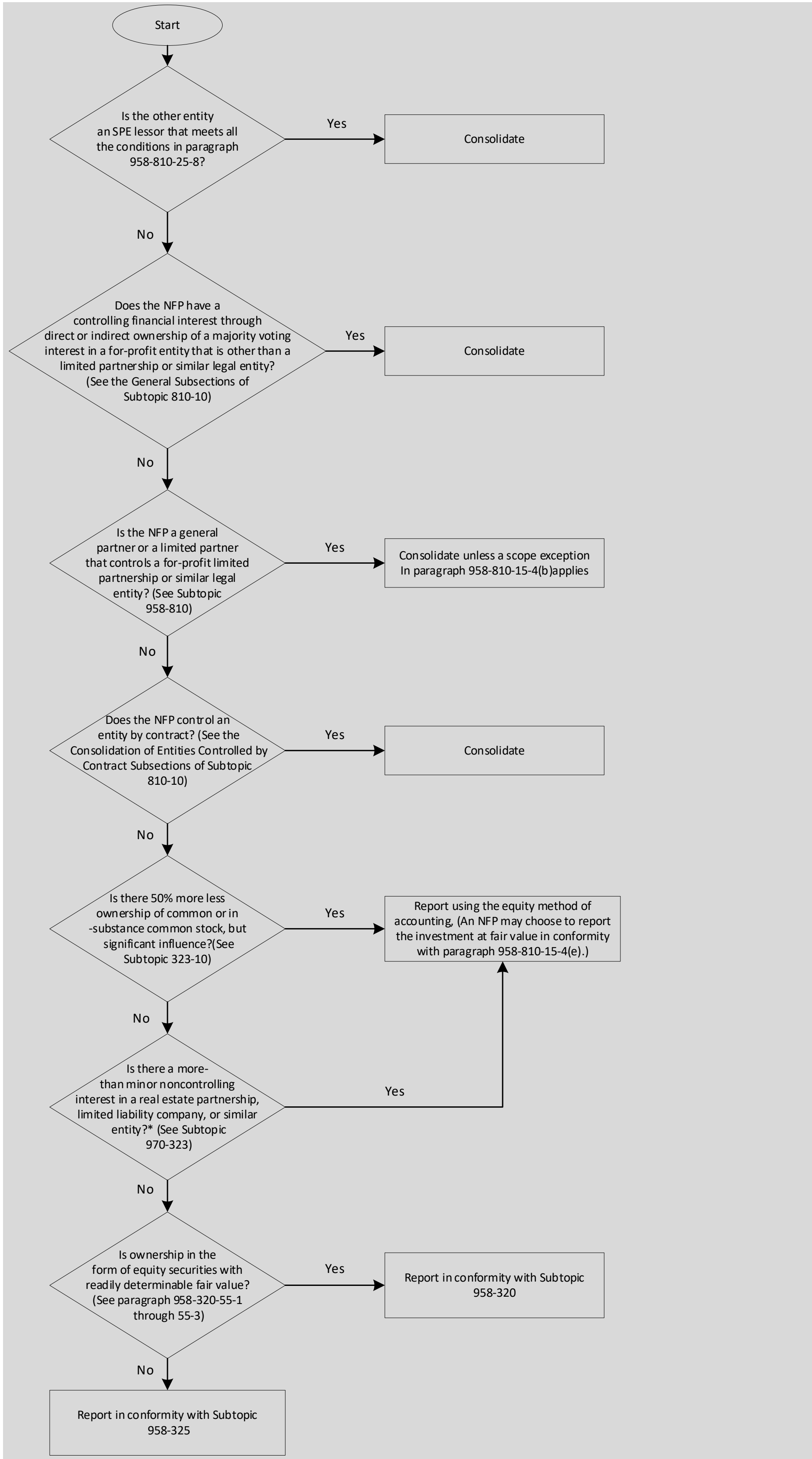
Excerpt from ASC 958-810

> Implementation Guidance

>> Flowcharts

>>> Relationship with a For-Profit Entity

55-4 The following flowchart and related footnote indicate the order in which an NFP applies the guidance elsewhere in the Codification to determine the accounting for its relationship with a for-profit entity.


Start
Is the other entity an SPE lessor that meets all the conditions in paragraph 958-810-25-8?
Yes
Consolidate
No
Does the NFP have a controlling financial interest through direct or indirect ownership of a majority voting interest in a for-profit entity that is other than a limited partnership or similar legal entity? (See the General Subsections of Subtopic 810-10)
Yes
Consolidate
No
Is the NFP a general partner or a limited partner that controls a for-profit limited partnership or similar legal entity? (See Subtopic 958-810)
Yes
Consolidate unless a scope exception In paragraph 958-810-15-4(b)applies
No
Does the NFP control an entity by contract? (See the Consolidation of Entities Controlled by Contract Subsections of Subtopic 810-10)
Yes
Consolidate
No
Is there 50% more less ownership of common or in -substance common stock, but significant influence?(See Subtopic 323-10)
Yes
Report using the equity method of accounting, (An NFP may choose to report the investment at fair value in conformity with paragraph 958-810-15-4(e).)
No
Is there a more-than minor noncontrolling interest in a real estate partnership, limited liability company, or similar entity?* (See Subtopic 970-323)
Yes
No
Is ownership in the form of equity securities with readily determinable fair value? (See paragraph 958-320-55-1 through 55-3)
Yes
Report in conformity with Subtopic 958-320
No
Report in conformity with Subtopic 958-325

*According to paragraph 323-30-35-3, a limited liability company that maintains a specific ownership account for each investor—similar to a partnership capital account structure—should be viewed as similar to an investment in a **limited partnership** for purposes of determining whether a noncontrolling investment in a limited liability company should be accounted for in accordance with the guidance in Topic 321 or the equity method.

Question 9.4.50

In what situations would an NFP general partner not consolidate a limited partnership?

Interpretive response: An NFP GP in a limited partnership is presumed to control the limited partnership, resulting in it consolidating the limited partnership. However, the GP does not control the limited partnership if the LPs have either: [958-810-25-14]

— substantive kick-out rights; or
— substantive participating rights.

Question 9.4.60

How are participating rights held by LPs considered when evaluating control by an NFP general partner?

Interpretive response: Participating rights of the LPs deemed to be substantive overcome the presumption that the GP has a controlling financial interest in the limited partnership. The FASB provides a list of participating rights and factors to consider, which are similar to the factors to consider in Subtopic 810-10 (see section 5.3).

Question 9.4.70

Do the rights of LPs and their impact on consolidation need to be reassessed on an ongoing basis?

Interpretive response: Yes. The assessment is performed when an investor first becomes an LP and reassessed at each reporting period. [958-810-25-18]

Question 9.4.80

Does an NFP lessee that provides a residual value guarantee to an SPE lessor consolidate the SPE?

Interpretive response: It depends. The SPE owner's equity investment must be at risk during the entire term of the lease for the NFP lessee to avoid consolidating the SPE. The effect of the residual value guarantee is that the NFP lessee has guaranteed the return of the owner's equity investment in the SPE during the period of the lease. Therefore, the owner's equity investment is not at risk during this period and the NFP needs to evaluate the other criteria in paragraph 958-810-25-8 to determine if it must consolidate the SPE. [958-810-25-8]

Example 9.4.10

Consolidation of an SPE lessor by an NFP lessee

Background

NFP Lessee provides a residual value guarantee to SPE lessor equal to the lesser of:

— the outstanding amount of the SPE's debt plus the amount of the owner's initial equity investment; and
— 80% of the cost of the leased asset.

The cost and fair value of the leased asset is $15 million. SPE has funded its purchase through a $600,000 equity investment from its owner and a $14.4 million mortgage.

The amount of the residual value guarantee NFP Lessee provides is capped at $12 million. However, rentals payable by NFP Lessee will exceed interest payable on the mortgage, and the outstanding mortgage balance is expected to approximate $10 million by the end of the lease.

Evaluation

The effect of the residual value guarantee is that NFP Lessee has guaranteed the return of the owner's equity investment in the SPE during the period of the lease in which the mortgage balance is under $11.4 million.

As a result, the owner's equity investment is not at risk during this period and consolidation may be required. NFP Lessee will need to evaluate the other considerations in paragraph 958-810-25-8 to determine if consolidation is required.

9.4.30 Presentation and disclosure

Excerpt from ASC 958-810

> Presentation of Noncontrolling Interests

45-1 Noncontrolling interests in the equity (net assets) of consolidated subsidiaries shall be reported as a separate component of the appropriate class of net assets in the consolidated statement of financial position of a not-for-profit entity (NFP). That amount shall be clearly identified and described (for example, as noncontrolling ownership interest in subsidiaries) to distinguish it from the components of net assets of the parent, which includes the parent's controlling financial interest in its subsidiaries. See paragraphs 958-810-50-4 through 50-5 for additional guidance on the requirement related to disclosure of noncontrolling interests either on the face of the statement of activities or in the notes. The effects of **donor-imposed restrictions**, if any, on a partially owned subsidiary's net assets shall be reported in accordance with Subtopics 958-205 and 958-220. Example 1 (see paragraphs 958-810-55-17 through 55-25) illustrates the reporting requirements.

> Additional Useful Information for Limited Partnerships

45-2 An entity has financial statement and disclosure alternatives that may provide additional useful information. For example, an entity may highlight the effects of consolidating a **limited partnership** by providing consolidating financial statements or separately classifying the assets and liabilities of the limited partnership(s) on the face of the balance sheet.

General

50-1 If consolidated financial statements are presented, the reporting entity (parent) shall disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled **not-for-profit entity** (NFP) (subsidiary) to the parent and any resulting unavailability of the net assets of the subsidiary for use by the parent.

50-2 If, as described in paragraph 958-810-25-4, an NFP (the reporting entity) controls a related but separate NFP through a form other than majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity and has an **economic interest** in that other NFP, the reporting entity shall disclose all of the following information if it does not present consolidated financial statements:

a. Identification of the other NFP and the nature of its relationship with the reporting entity that results in **control**
b. Summarized financial data of the other NFP, which shall include the following information:
   1. Total assets, liabilities, net assets, revenue, and expenses
   2. Resources that are held for the benefit of the reporting entity or that are under its control.
c. The disclosures required by paragraphs 850-10-50-1 through 50-6.

50-3 The existence of control or an economic interest, but not both, as described in paragraph 958-810-25-5, requires the disclosures in paragraphs 850-10-50-1 through 50-6. (The existence of an economic interest does not necessarily cause the entities to be **related parties**. However, the disclosures in those paragraphs are required if an economic interest exists.)

> Disclosures for Noncontrolling Interests

50-4 An NFP (parent) that has one or more consolidated subsidiaries with a **noncontrolling interest** shall provide a schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest either in notes to the consolidated financial statements or on the face of financial statements, if practicable. That schedule shall reconcile beginning and ending balances of the parent's controlling interest and the noncontrolling interests for each class of net assets for which a noncontrolling interest exists during the reporting period.

50-5 The schedule required by the preceding paragraph shall, at a minimum, include:

a. A performance indicator, if the entity is a not-for-profit, business-oriented health care entity (see Section 954-10-15)
b. Amounts of discontinued operations
c. Subparagraph superseded by Accounting Standards Update No. 2015-01.
d. Changes in ownership interests in a subsidiary, including investments by and distributions to noncontrolling interests acting in their capacity as owners, which shall be reported separate from any revenues, expenses, gains, or losses and outside any measure of operations, if reported
e. An aggregate amount of all other changes in **net assets without donor restrictions** and **net assets with donor restrictions** for the period.

50-6 Paragraph 958-810-55-25 illustrates the required disclosures using a reconciling schedule in notes to the consolidated financial statements.

Excerpt from ASC 954-810

45-1 Whether the financial statements of a reporting health care entity and those of one or more other for-profit entities or not-for-profit entities (NFPs) shall be consolidated, whether those other entities shall be reported using the equity method, and the extent of disclosure that is be required (if any) if consolidated financial statements are not presented, shall be based on the nature of the relationship between the entities. See paragraphs 954-810-15-2 through 15-3.

45-2 Paragraph 958-810-25-2A explains that, in some situations, certain actions require approval by a supermajority vote of the board. That paragraph states that such voting requirements might overcome the presumption of control by the owner or holder of a majority voting interest. (For related implementation guidance, see paragraph 958-810-55-4A.) Pursuant to paragraph 810-10-15-17(a) a not-for-profit, business-oriented health care entity is not subject to the Variable Interest Entities Subsections of Subtopic 810-10, except that it may be a related party for purposes of applying paragraphs 810-10-25-42 through 25-44. Also, if a not-for-profit, business-oriented health care entity is used by business entities in a manner similar to a variable interest entity (VIE) in an effort to circumvent the provisions of the Variable Interest Entities Subsections of Subtopic 810-10, that not-for-profit entity shall be subject to the Variable Interest Entities Subsections of that Subtopic.

45-3 Paragraph not used.

45-3A A parent corporation typically owns stock in a for-profit entity, whereas a sole corporate member holds membership rights in a not-for-profit entity. Sole corporate membership in a not-for-profit entity, like ownership of a majority voting interest in a for-profit entity, shall be considered a controlling financial interest, unless control does not rest with the sole corporate member (for instance, if the other [membership] entity is in bankruptcy or if other legal or contractual limitations are so severe that control does not rest with the sole corporate member).

45-3B When consolidated financial statements are required or permitted by Section 958-810-25, a noncontrolling interest shall be provided if such interest is represented by an economic interest whereby the noncontrolling interest would share in the operating results or residual interest upon dissolution. (See presentation and disclosure requirements in Sections 958-810-45 and 958-810-50, respectively.)

45-3C Not-for-profit, business-oriented health care entities shall not report an investment in an entity at fair value, as described in paragraph 958-325-35-6, if that entity is required to be consolidated.

> Medical Malpractice Claims

45-4 In general, a trust fund, whether legally revocable or irrevocable, shall be included in the financial statements of the health care entity. A portion of the fund equal to the amount of assets expected to be liquidated to pay malpractice claims classified as current liabilities shall be classified as a current asset; the balance of the fund, if any, shall be classified as a noncurrent asset. Revenues and administrative expenses of the trust fund are included in the statement of operations. In some circumstances, the foregoing may not be possible (for example, if a common trust fund exists for a group of health care entities; if the health care entity is part of a common municipality risk-financing internal service fund; or if the legal, regulatory, or indenture restrictions prevent the inclusion of a trust fund in a health care entity's financial statements).

> Medical Malpractice Trust Fund

50-1 The existence of the trust fund and whether it is irrevocable shall be disclosed in the financial statements.

> Noncontrolling Interests

50-2 A not-for-profit, business-oriented health care entity shall include the performance indicator in the schedule required by paragraphs 958-810-50-4 through 50-5. Paragraph 958-810-55-25 illustrates the required disclosure using a reconciling schedule in notes to the consolidated financial statements.

The presentation and disclosure requirements associated with NCI of an NFP are similar to those of Topic 810, meaning the NCI must be clearly presented as a separate item of net assets. However, there are some considerations regarding NFPs (e.g. donor-imposed restrictions) that may require additional disclosures. [958-810-45-1]

Paragraphs 958-810-55-17 to 55-25 below provide illustrative examples of presentation and disclosures associated with NCI.

NFPs should also consider presentation and disclosures associated with the following:

- limited partnerships; [958-810-42-2]
- restrictions on distributions made by entities outside of the reporting entity; [958-810-50-1]
- when control exists by other than majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity and an economic interest is present; and [958-810-50-2]
- the existence of control or economic interest, but not both. [958-810-50-3]

Subtopic 954-810 (health care entities) also provides incremental presentation and disclosure guidance for NFPs in its scope.

Excerpt from ASC 958-810

> Illustrations

>> Example 1: Subsidiary with a Noncontrolling Interest

55-17 This Example illustrates one way in which the consolidated financial statements of an NFP might satisfy the presentation and disclosure requirements for noncontrolling interests in a consolidated subsidiary and subsequent changes in ownership interests of that subsidiary. This Example uses simplified assumptions and highly aggregated amounts to illustrate how to apply the provisions of Topic 810 and Subtopic 958-810.

55-18 For example, the consolidated statement of financial position in paragraph 958-810-55-23 shows relatively few highly aggregated amounts of assets and liabilities, and the consolidated statement of operations and other changes in **net assets without donor restrictions** in paragraph 958-810-55-24 shows relatively few highly aggregated amounts of revenues and expenses rather than details such as expenses by function or nature. The consolidated statement of financial position also does not classify assets and liabilities, which is required for a not-for-profit, business-oriented health care entity by paragraph 954-210-45-1. This Example also omits a statement of cash flows, which does not bear on the presentation and disclosure requirements for noncontrolling interests.

55-19 Formats or levels of detail other than those presented in this Example may be appropriate for other situations. For example, the related net assets and noncontrolling interest would be presented in **net assets with donor restrictions** if **donor-imposed restrictions** on the use of the subsidiary's net assets existed in this Example (see paragraph 958-810-45-1).

>>> Assumptions

55-20 The following assumptions are applicable to all years:

a. Hospital A, a tax-exempt NFP has one subsidiary, Subsidiary A. That ownership interest in Subsidiary A was purchased; there are no donor-imposed restrictions on the use of Subsidiary A's net assets.
b. Subsidiary A is an investor-owned entity that is subject to income taxes. The tax rate for all years is 40 percent.
c. Subsidiary A has 10,000 shares of common stock outstanding and does not pay dividends.

55-21 The following assumptions are applicable to 20X2:

a. On January 1, 20X2, Hospital A sells 2,000 of its 10,000 shares in Subsidiary A to an unrelated entity for $50,000 in cash, reducing its ownership interest from 100 percent to 80 percent. Immediately before the sale, Subsidiary A's equity was as follows.

	Subsidiary A
Common stock	$ 25,000
Paid-in capital	50,000
Retained earnings	125,000
Accumulated other comprehensive income	5,000
Total equity	$ 205,000

b. The accumulated other comprehensive income balance of $5,000 represents an unrealized gain on a portfolio of debt securities purchased by Subsidiary A for $100,000, which it classifies as available-for-sale debt securities at the carrying amount of $105,000 and are the only investment securities of the consolidated group.
c. The sale of Subsidiary A's shares is accounted for as an equity transaction (within **net assets without donor restrictions**) in the consolidated financial statements of Hospital A, as follows:

   1. A noncontrolling interest is recognized in net assets without donor restrictions in the amount of $41,000 ($205,000 × 20 percent).
   2. Net assets without donor restrictions attributable to Hospital A are increased by $9,000, calculated as the difference between the cash received ($50,000) and the carrying amount of the noncontrolling interest ($41,000).
   3. The top-level (consolidated) journal entry to record the sale of Subsidiary A's shares to the noncontrolling shareholder is as follows:

Cash	$ 50,000	
Net assets without donor restrictions (noncontrolling interest)		$ 41,000
Net assets without donor restrictions (Hospital A)		9,000

d. For the year ended December 31, 20X2, the amount of Subsidiary A's net income included in the consolidated financial statements is $20,000, which included a net loss for discontinued operations of $7,000.

55-22 The following assumptions are applicable to 20X3:

a. On January 1, 20X3, Hospital A purchases 1,000 shares in Subsidiary A from the noncontrolling shareholders (50 percent of the noncontrolling interest) for $30,000 cash, increasing its ownership interest from 80 percent to 90 percent. Immediately before that purchase, the carrying amount of the noncontrolling interest in Subsidiary A was $48,000. The purchase of shares from the noncontrolling shareholders is accounted for as an equity transaction in the consolidated financial statements, as follows:

   1. The noncontrolling interest balance within net assets without donor restrictions is reduced by $24,000 ($48,000 × 50 percent interest acquired by Hospital A).
   2. Net assets without donor restrictions attributable to Hospital A are decreased by $6,000, calculated as the difference between the cash paid ($30,000) and the adjustment to the carrying amount of the noncontrolling interest ($24,000).
   3. The top-level (consolidated) journal entry to record that purchase of Subsidiary A's shares from the noncontrolling shareholders is as follows:

Net assets without donor restrictions (noncontrolling interest)	$ 24,000	
Net assets without donor restrictions (Hospital A)	6,000	
Cash		$ 30,000

b. For the year ended December 31, 20X3, the amount of Subsidiary A's net income included in the consolidated financial statements is $15,000.

>>> Consolidated Statement of Financial Position

55-23 The following consolidated statement of financial position illustrates the requirement in paragraph 958-810-45-1 that Hospital A present the noncontrolling interest in the consolidated statement of financial position within net assets, but separately from the parent's net assets.

Hospital A
Consolidated Statement of Financial Position
As of December 31

	20X3	**20X2**
Assets:		
Cash	$ 570,000	$ 475,000
Accounts receivable	125,000	110,000
Investment securities	125,000	120,000
Plant and equipment	220,000	235,000
Total assets	$ 1,040,000	$ 940,000
Liabilities:		
Total liabilities	$ 555,000	$ 459,000
Net assets without donor restrictions:		
Hospital A	459,000	433,000
Noncontrolling interests in Subsidiary A	26,000	48,000
Total net assets without donor restrictions	485,000	481,000
Total liabilities and net assets	$ 1,040,000	$ 940,000

>>> Consolidated Statement of Operations and Other Changes in Net Assets without Donor Restrictions

55-24 The following consolidated statement of operations and other changes in **net assets without donor restrictions** illustrates how the requirements in paragraph 958-810-50-5(a) for disclosure of the amounts of a performance indicator of a health care entity for an excess of revenues over expenses from continuing operations and in paragraph 958-810-50-5(b) for discontinued operations might be presented on the face of a consolidated statement of operations and other changes in net assets.

Hospital A
Consolidated Statement of Operations and Other Changes in Net Assets without Donor Restrictions
Year Ended December 31

	20X3	20X2
Revenues, gains, and other support without donor restrictions:		
Net patient service revenue	$ 390,000	$ 355,000
Contributions	5,000	5,000
Net assets released from donors' restrictions used for operations	—	—
Total revenues, gains, and other support	$ 395,000	$ 360,000
Patient care and other operating expenses	366,000	337,000
Excess of revenues over expenses (from continuing operations)	29,000	23,000
Discontinued operations of Subsidiary A, net	—	(7,000)
Change in net unrealized gains and losses on other than trading debt securities	5,000	15,000
Sale of Subsidiary A shares to noncontrolling shareholders	—	50,000
Purchase of Subsidiary A shares from noncontrolling shareholders	(30,000)	—
Increase in net assets without donor restrictions	$ 4,000	$ 81,000

>>> Notes to Consolidated Financial Statements: Changes in Consolidated Net Assets without Donor Restrictions Attributable to the Parent's Controlling Financial Interest and to Noncontrolling Interests in Subsidiaries

55-25 The following note depicts the changes in consolidated net assets attributable to the controlling financial interest of Hospital A (parent) and the noncontrolling interests. It illustrates the requirements in paragraph 958-810-50-4 that an NFP present a schedule that reconciles the beginning and the end of the period carrying amounts of the parent's controlling interest and the noncontrolling interests for each class of net assets for which a noncontrolling interest exists. This note also illustrates the disclosure requirements in paragraph 958-810-50-5(a) through (b) and (d) through (e) for the amounts of a performance indicator of a health care entity (which is equivalent to income from continuing operations), for the amounts of discontinued operations, changes in ownership interests in a subsidiary, and the aggregate amount of all other changes in **net assets without donor restrictions** and **net assets with donor restrictions** for the period.

Hospital A
Notes to Consolidated Financial Statements
Changes in Consolidated Net Assets without Donor Restrictions Attributable to Hospital A and Transfers (to) from the Noncontrolling interest
Year Ended December 31

	Total	Controlling Interest	Noncontrolling Interest
Balance January 1, 20X2	$ 400,000	$ 400,000	$ —
Excess of revenues over expenses (from continuing operations)	23,000	17,600	5,400
Discontinued operations, net of tax	(7,000)	(5,600)	(1,400)
Change in net unrealized gains and losses on other than trading securities	15,000	12,000	3,000
Sale of Subsidiary A shares to noncontrolling shareholders	50,000	9,000	41,000
Change in net assets	81,000	33,000	48,000
Balance December 31, 20X2	$ 481,000	$ 433,000	$ 48,000
Excess of revenues over expenses from continuing operations	29,000	27,500	1,500
Change in net unrealized gains and losses on other than trading securities	5,000	4,500	500
Purchase of Subsidiary A shares from noncontrolling shareholders	(30,000)	(6,000)	(24,000)
Change in net assets	4,000	26,000	(22,000)
Balance December 31, 20X3	$ 485,000	$ 459,000	$ 26,000

>> Example 2: Limited Partnerships and Similar Legal Entities—Simple Majority Threshold for the Application of Kick-Out Rights

55-26 This Example illustrates the guidance in paragraphs 958-810-25-19 through 25-20. To illustrate the application of the simple majority threshold, consider the following Cases A, B, and C in which the **limited partnership** agreement requires a simple majority of the limited partners' voting interests to remove the general partner and Case D in which a supermajority of the limited partners' voting interests is required for such removal:

a. Three equal-interest limited partners (Case A)
b. Two equal-interest limited partners (Case B)
c One hundred equal-interest limited partners (Case C)
d. Required limited partner voting percentages greater than 50 percent (Case D).

>>> Case A: Three Equal-Interest Limited Partners

55-27 Assume that a limited partnership has 3 limited partners, none of which have any relationship to the general partners, and that each holds an equal amount of the limited partners' voting interests (33.33 percent). In this Case, applying the simple majority requirement in the partnership agreement would require a vote of no more than two of the three limited partners to remove the general partners. Accordingly, a provision that entitles any individual limited partner to remove the general partner or a provision that requires a vote of two of the limited partners to remove the general partner would meet the requirements of paragraph 958-810-25-19(a) for a substantive **kick-out right**. However, if a vote of all three limited partners is required to remove the general partner, the right would not meet the requirements of that paragraph for a substantive kick-out right because the required vote is greater than a simple majority of the limited partners voting interests.

>>> Case B: Two Equal-Interest Limited Partners

55-28 Consider the same facts as in Case A, except that there are two limited partners that each hold an equal interest. In this Case, a simple majority of the limited partners' voting interests would require a vote of both limited partners, so a provision entitling any individual limited partner to remove the general partner or a provision that requires a vote of both limited partners to remove the general partner would meet the requirements of paragraph 958-810-25-19(a) for a substantive kick-out right.

>>> Case C: One Hundred Equal-Interest Limited Partners

55-29 Consider the same facts as in Case A, except that there are 100 limited partners that each hold an equal interest. In this Case, a simple majority of the limited partners' voting interests would require a vote of 51 limited partners; therefore, a provision that requires a vote of less than 52 limited partners to remove the general partner would meet the requirements of paragraph 958-810-25-19(a) for a substantive kick-out right. However, if a vote of 52 or more limited partners is required to remove the general partner, that provision would not meet the requirements of that paragraph for a substantive kick-out right because the required vote is greater than a simple majority of the limited partners' voting interests.

>>> Case D: Required Limited Partner Voting Percentages Greater Than 50 Percent

55-30 In this Case, consider the following situations based on a limited partnership agreement that requires a vote of 66.66 percent of the limited partners' voting interests to remove the general partner:

a. Equal-interest limited partners (Case D1)
b. Limited partners with unequal interests (Case D2).

>>>> Case D1: Equal-Interest Limited Partners

55-31 There are 3 independent limited partners that each hold an equal percentage (33.33 percent) of the limited partner voting interest. A vote of 2 of the 3 limited partners represents 66.66 percent of the limited partners voting interests, which also represents the smallest possible combination of voting interests that is at least a simple majority of the limited partners' voting interests. Assuming there are no barriers to the exercise of the kick-out rights, the kick-out rights in this Case meet the simple majority requirement and, therefore, represent substantive kick-out rights that overcome the presumption of control by the general partners.

>>>> Case D2: Limited Partners with Unequal Interests

55-32 There are 3 independent limited partners that hold 45 percent (Limited Partner 1), 25 percent (Limited Partner 2), and 30 percent (Limited Partner 3) of the limited partners' voting interests, respectively. To remove the general partners, a vote of Limited Partner 1 in combination with either Limited Partner 2 or Limited Partner 3 would be a simple majority of the limited partners' voting interests and would satisfy the 66.66 percent contractual requirement. In contrast, a vote to exercise the kick-out right by Limited Partner 2 and Limited Partner 3 also would represent a simple majority of the limited partners' voting interests, but their 55 percent voting interests would not meet the contractually required threshold of 66.66 percent to remove the general partners. Accordingly, the kick-out right in this Case would be assessed as nonsubstantive because the smallest possible combination (Limited Partner 2 and Limited Partner 3) that represents at least a simple majority of the limited partners' voting interests cannot remove the general partners. Assuming the limited partners do not possess substantive participating rights, the presumption of control by the general partners would not be overcome.

10. Expected losses and residual returns

Detailed contents

Examples

10.3 Allocating expected losses and expected residual returns to variable interests

Questions

Example

10.1 How the standard works

Expected losses and expected residual returns are two of the key concepts in applying the VIE consolidation model. These two concepts – collectively referred to as expected variability – are used as the measure of a legal entity's economic risks and rewards.

Expected losses and expected residual returns (i.e. expected variability) are relevant in identifying variable interest holders (see chapter 3) and determining whether a legal entity is a VIE (see chapter 4).

This chapter explains how to calculate and allocate a legal entity's expected variability, as follows:

1	Identify cash flows, excluding cash flows related to: — variable interests; and — risks the legal entity was not designed to create and distribute.
2	Determine expected losses and expected residual returns by calculating the present value of the identified cash flows using the expected cash flow approach in FASB Concepts Statement No. 7 (CON 7), Using Cash Flow Information and Present Value in Accounting Measurements.
3	Allocate expected losses and expected residual returns to variable interests, if required.

10.2 Calculating expected losses and expected residual returns

10.2.10 Overview

Excerpt from ASC 810-10

20 Glossary

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.

The concepts of expected losses and expected residual returns are some of the most difficult to understand and apply in Subtopic 810-10. Unfortunately, they are not intuitive, in part because the labels given to them do not convey the fundamental underlying concepts. In particular, expected losses do not represent the US GAAP losses that investors expect the legal entity to incur. Similarly, expected residual returns do not represent US GAAP net income that investors expect the legal entity to produce.

Instead, these concepts are based on the present value of a legal entity's cash flows, which leads to the following questions.

— Which cash flows are used to calculate expected losses and expected residual returns?
— How is the present value of those cash flows determined?

Question 10.2.10

Why is the expected cash flow approach used under Subtopic 810-10?

Interpretive response: Subtopic 810-10 requires the expected cash flow methodology to be used to calculate expected losses and expected residual returns because an expected cash flow distribution gives rise to mathematical variability around the overall arithmetic mean (i.e. the 'expected cash flows'). This is important because Subtopic 810-10 uses that variability as the measure of an entity's economic risks and rewards.

Although the basis for determining a legal entity's overall fair value under Topic 820 is often also based on an expected cash flow distribution, the overall expected cash flows used to compute variability is not a fair value measurement (see Question 10.2.20).

In Subtopic 810-10, each estimated cash flow in an expected cash flow estimate, when compared with overall expected cash flows (i.e. the weighted average), results in a positive or negative difference. These positive and negative differences, when multiplied by the probabilities associated with the individual estimated cash flows, represent the potential for variability in cash flows from the expected (or weighted average) cash flows.

Expected losses comprise the negative amounts (negative variability) and expected residual returns comprise the positive amounts (positive variability). It is a mathematical certainty in this approach that negative variability and positive variability will always offset each other (i.e. they are equal and opposite) as illustrated in the calculation of expected cash flows in Subtopic 810-10's Example 1 (see section 10.2.30).

Question 10.2.20

How do fair value measurements under Topic 820 differ from calculations of expected losses and expected residual returns under Subtopic 810-10?

Background: The guidance in Topic 820 provides a framework for US GAAP fair value measurements and disclosure requirements related to fair value measurements. Under that guidance, a risk premium (i.e. the price market participants would demand for bearing uncertainty in future cash flows) is an element of a fair value measurement of an asset or liability. A risk premium is reflected as an adjustment of the discount rate in a discounted cash flow analysis under either the traditional or probability-weighted expected cash flow approaches. [820-10-55-5(d)]

Interpretive response: The guidance in Subtopic 810-10 on expected loss calculations incorporates by reference the guidance in CON 7, which was not amended by FASB Statement No. 157, Fair Value Measurements. Further, expected cash flows, expected losses and expected residual returns under Subtopic 810-10 do not necessarily represent fair value measurements.

Subtopic 810-10 requires the present value of expected cash flows to be determined using a risk-free discount rate (see Question 10.2.40). A risk-free discount rate excludes any risk premium, meaning the compensation demanded by market participants for bearing the risk of uncertain cash flows may not be included in the calculation of expected losses and expected residual returns. However, the uncertainty in the timing and amount of the cash flows is reflected in the probability weighting of the expected cash flows. As a result, although the measurements are not the same, an enterprise should be able to reconcile expected discounted cash flows to fair value (see Question 10.2.110).

Identifying cash flows

Question 10.2.30

Which cash flows are used to calculate expected losses and expected residual returns?

Interpretive response: A legal entity's expected losses and expected residual returns measure the variability in the fair value of the entity's net assets – i.e. the variability **created** by those assets. This variability is measured through the entity's expected cash flows.

However, the following two types of cash flows are disregarded.

Cash flows attributable to any variable interests in the entity

These cash flows are excluded because they absorb the legal entity's variability instead of creating it. Examples include fees paid to certain service providers, certain derivative contracts and investments in equity or debt.

Cash flows attributable to risks the legal entity was not designed to create and distribute

Only the specific risks a legal entity was designed to create and distribute to its interest holders are included when calculating the legal entity's expected losses and expected residual returns and determining the variable interests. The by-design approach (see section 3.3) may result in variations in cash flows being excluded from the calculations if they do not arise from risks the legal entity is designed to create and distribute to its interest holders.

For example, variations in cash flows arising from interest rate risk may affect the fair value of a legal entity's net assets but may be excluded in calculating the entity's expected cash flows; this is because interest rate risk is not a risk the entity is designed to create and distribute to its interest holders. As a result of the by-design approach, the present value of a legal entity's expected cash flows may not necessarily equal the fair value of its net assets excluding variable interests. [810-10-25-21 – 25-29]

Calculating expected losses and expected residual returns

Question 10.2.40

What present value approach must be used to determine expected losses and expected residual returns?

Interpretive response: Subtopic 810-10 requires use of the expected cash flow approach to determine present value, as described in CON 7, Using Cash Flow Information and Present Value in Accounting Measurements. [810-10 Glossary]

Expected cash flow approach

The expected cash flow approach determines present value using the range of estimated cash flows and the respective probabilities associated with each of the individual cash flow estimates.

Simple illustration

CON 7 provides a simple illustration of the expected cash flow approach. An entity estimates it will receive $1,000 sometime in the next three years. It assigns the following probabilities and discount rates as to when it will receive the cash. [CON7.46]

Receipt in:	Probability of occurrence	Discount rate
one year	10%	5.00%
two years	60%	5.25%
three years	30%	5.50%

The expected cash flow approach yields a present value calculation of $892. This calculation is based on the weighted average of each of the individual cash flows multiplied by their respective probabilities of occurrence and discounted using the appropriate discount rates.

Details of the approach

The probabilities must total 100% for a specific expected cash flow estimate. Each estimated cash flow is discounted to present value using a risk-free interest rate (e.g. US Treasury rates in the United States) and is multiplied by the applicable probability to compute the overall expected cash flow. Using a risk-free interest rate to discount the cash flows results in a present value that incorporates only the time value of money via the discount rate.

In applying the CON 7 approach, the uncertainties associated with the present value estimate are reflected in the distribution of estimated cash flows – i.e. different estimated amounts and timing. The following factors are reflected in the expected cash flows and therefore should not be included in the discount rate:

- expectations about possible variations in the amount or timing of cash flows;
- the price for bearing the uncertainty inherent in the asset or liability; and
- other (sometimes unidentifiable) factors, including illiquidity and market imperfections.

Question 10.2.50

Can the present value of expected losses and expected residual returns be determined using approaches other than expected cash flows?

Interpretive response: No. Although CON 7 is not a part of authoritative generally accepted accounting principles, Subtopic 810-10 specifically requires use of the expected cash flow approach as described in CON 7. It does so through its definition of expected losses and expected residual returns. [810-10 Glossary]

Therefore, the expected cash flow approach must be used for this calculation even if the legal entity's assets or liabilities otherwise justify the use of:

— the best estimate approach described in CON 7 (the single most likely cash flow discounted to a present value); or
— other approaches discussed in Topic 820 (fair value measurements).

Question 10.2.60

Is there a minimum number of possible cash flow scenarios that should be included in calculating expected losses and expected residual returns?

Interpretive response: Subtopic 810-10 does not require a minimum number of possible outcomes to be included when calculating expected losses and expected residual returns. Determining the number of cash flow scenarios to use requires judgment based on the legal entity's specific facts and circumstances.

As the number of cash flow scenarios included in the calculation of expected losses and expected residual returns increases, the level of probability (and the relative effect on the overall result) assigned to each individual scenario will necessarily decrease. Nevertheless, we believe a calculation that includes only a very limited number of scenarios (e.g. base case, best case and worst case) will generally not appropriately quantify expected losses and expected residual returns.

In general, we believe there is a direct relationship between the relative complexity of a legal entity's assets and the number of cash flow scenarios that should be included in the calculation. Specifically, as the relative complexity of a legal entity's assets increases, it will generally be necessary to include a greater number of cash flow scenarios. However, it is generally not necessary to add additional cash flow scenarios to the calculation if doing so would not affect the determination of whether the legal entity is a VIE.

In our experience, expected loss calculations fall into two general categories. The selection of the appropriate approach depends on the specific facts and circumstances. Approaches that do not fall into either of these two general categories may also achieve the objectives of Subtopic 810-10 depending on the relevant facts and circumstances.

Base case approach

The first category of calculations is relatively simple. It typically begins with a base case or most likely outcome to which additional cash flow scenarios are added based on changes to the assumptions in the base case. Probabilities are assigned to each cash flow scenario (including the base case). The calculations in this category generally include a much smaller number of cash flow scenarios than the calculations in the second category.

Option modeling approach

A second more complicated category of calculations uses option modeling techniques (e.g. a Monte Carlo simulation). The use of option modeling techniques generally requires valuation or other specialists with the requisite professional skills to be involved in preparing or overseeing the preparation of the calculations and ensuring that their results are consistent with the requirements of Subtopic 810-10. We have most frequently seen such calculations in legal entities that predominantly comprise financial assets. Option modeling techniques may generate hundreds of thousands of cash flow scenarios that are used to calculate expected losses and expected residual returns.

Question 10.2.70

Are there different acceptable methods for computing the present value of expected cash flows?

Interpretive response: Yes. In our experience, two primary methods are used to discount a legal entity's expected cash flows in the expected variability calculation: the fair value method and the cash flow method. The methods differ mainly in which interest rate curve to use when discounting the entity's expected cash flows.

Fair value method

Under the fair value method, variability is based on expected fair value changes. The present value of an entity's expected cash flows is calculated by projecting multiple possible cash flow outcomes under a variety of risk-free interest rate environments and discounting the cash flows using the yield curve from those respective environments.

For example, under this method, there is variability identified for a fixed-rate debt security due to changes in interest rates. This occurs because the discounted cash flow amount under each interest rate scenario will differ from the instrument's current fair value. Although the undiscounted cash flow amount does not change in each scenario, the discount rate does because each cash flow scenario is discounted using a different possible risk-free interest rate yield curve.

Conversely, there is no variability identified for a variable-rate debt security due to changes in interest rates when the fair value method is used. This occurs because the discounted cash flow amount under each interest rate scenario will not differ from the instrument's current fair value. The undiscounted cash flow amount in each interest rate scenario changes alongside the discount rate applied to each of those scenarios.

Cash flow method

Under the cash flow method, variability is based on expected cash flow changes. The present value of an entity's expected cash flows is calculated by projecting multiple possible cash flow outcomes under a variety of risk-free interest rate environments and discounting the cash flows using only the yield curve that exists at the date the calculation is performed.

For example, under this method, there is no variability identified for a fixed-rate debt security due to changes in interest rates. This occurs because the discounted cash flow amount under each interest rate scenario will not differ from the instrument's current fair value. The undiscounted cash flow amount does not change in each interest rate scenario and neither does the discount rate.

Conversely, there is variability identified for a variable-rate debt security due to changes in interest rates. This occurs because the discounted cash flow amount under each interest rate scenario will differ from the instrument's current fair value. The undiscounted cash flow amount changes in each interest rate scenario but the discount rate does not.

Hybrid method

A hybrid method that also is used in practice is designed to eliminate interest rate risk as a creator of variability in the calculation of expected losses and expected residual returns. Under this method, which is a hybrid of the cash flow and fair value methods, projected cash flows from fixed-rate interest-bearing assets are discounted at a single discount rate using the yield curve that exists at the date the calculation is performed.

Further, projected cash flows from variable-rate interest-bearing assets are discounted at rates that reflect the different yield curves giving rise to the variable cash flows in various possible interest rate environments. The result is that there is little or no variability in the present value of expected cash flows due to changes in interest rates.

Accounting policy election

We believe an enterprise should use a single method to measure expected losses and expected residual returns for any given legal entity. However, because different legal entities have different designs, we believe an enterprise need not use the same method for all legal entities.

To mitigate concerns about inconsistencies in how expected losses and expected residual returns are measured for similar legal entities, we believe an enterprise should apply a consistent method to legal entities with similar designs.

Question 10.2.80

How are expected losses and expected residual returns calculated for a legal entity with an indefinite life?

Interpretive response: A legal entity has an indefinite life if it expects to continue operating with no definite exit plan. We believe it is acceptable to calculate expected losses and expected residual returns for such a legal entity by projecting:

- operating cash flows for a judgmentally determined number of years based on the legal entity's design; and
- a terminal value obtained upon a theoretical disposition of the legal entity's net assets exclusive of variable interests.

If the terminal value is based on a measure of operating cash flows (e.g. computed as a fixed multiple of trailing EBITDA), we expect those operating cash flows to be consistent with those assumed for years preceding the theoretical disposition.

Question 10.2.90

Can a legal entity that has no history of net losses and expects to continue to be profitable in the foreseeable future have expected losses?

Interpretive response: Yes. Subtopic 810-10's definition of expected losses states a "legal entity that expects to be profitable will have expected losses." This is because of how the calculation works mechanically. Expected losses (and residual returns) are measured by computing each cash flow scenario and comparing it to the weighted average of all the cash flow scenarios (i.e. the 'expected cash flows'). When there are cash flow scenarios that result in amounts lower than the expected cash flows, those differences represent the expected losses. Likewise, when there are scenarios that result in amounts greater than the expected cash flows, those differences represent the expected residual returns. Subtopic 810-10's Example 2 illustrates this (see section 10.2.30).

Question 10.2.100

How are tax benefits related to a legal entity's assets considered if they are received directly by the equity investors?

Background: This issue arises in affordable housing limited partnerships. For example, an affordable housing limited partnership is formed to develop and operate a multifamily housing project. Provided that a specified number of the housing units remain affordable for at least 15 years to tenants who earn 60% or less of the area median income, investors in the partnership are eligible for a

10-year federal income tax credit on their investment. The tax credits do not affect the net income or cash flows of the limited partnership but do affect the value of the property and the value of the investors' interests in the partnership.

Interpretive response: It depends on the facts and circumstances.

In general, if the tax benefits received directly by variable interest holders affect the fair value of the legal entity's assets, we believe the effect of those benefits should be considered in calculating the entity's expected losses and expected residual returns. This is because, in that case, they likely represent a source of variability the entity was designed to create and distribute to its interest holders.

Conversely, when the direct tax effects to variable interest holders of their investments in an entity do not affect the fair value of the entity's assets, we believe the variable interest holders' tax effects generally should not be considered in calculating the entity's expected losses and expected residual returns because the tax effects occur outside the entity.

We understand the SEC staff also holds this view.

When an investor's return on an investment results primarily from tax benefits, we believe the tax benefits typically affect the fair value of the entity's assets. Indicators that an investor's return results primarily from tax benefits include, but are not limited to, the following:

— without the tax benefits from the investment, the investor would incur a loss on its investment or its return would be substantially below market in relation to the risk of its investment;

— the investor has received a third-party guarantee (often from another variable interest holder) of the tax benefits to be received on its investment in the legal entity; and

— the acquisition cost of the investment is primarily determined based on the tax benefits it is projected to generate for the investor.

Question 10.2.110

Should an enterprise be able to reconcile expected discounted cash flows to the fair value of net assets?

Interpretive response: We believe that an enterprise generally should be able to reconcile the present value of a legal entity's expected cash flows under the by-design approach to the fair value of the entity's net assets (exclusive of variable interests). However, because fair value is an exit price notion and that exit price may or may not be easily derived from or reconciled back to the expected cash flow calculation performed under CON 7, comparing the two amounts may be challenging.

If a legal entity's fair value (exclusive of variable interests) can be derived from the expected cash flow calculation, comparing the entity-level expected cash flows to the expected cash flows attributable to the entity's variable interests under the by-design approach may help to ensure that the entity-level expected cash flows have been appropriately determined.

10.2.20 Calculation of expected losses and expected residual returns

When determining whether a legal entity is a VIE and identifying its primary beneficiary, an enterprise needs to calculate the entity's expected losses and expected residual returns. The following examples work through the same fact pattern to calculate these amounts for a legal entity that operates an aircraft.

Examples 10.2.10 to 10.2.30 assume there is no interest in specified assets (see section 3.6) of the legal entity. In contrast, Example 10.2.40 introduces a variable interest in specified assets of the legal entity.

Example 10.2.10

Step 1: Calculating the present value of expected cash flows from operations

Legal Entity operates an aircraft. Enterprise is calculating Legal Entity's expected cash flows over five years. The timing of the cash flows is assumed to be certain, but the amount of cash flows could vary.

Table 1
Cash flows from aircraft operations[1]
($'000s)

A	B[2]	C	D = B × C
Estimated annual cash flows[3]	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows
$6,247	$27,812	15%	$4,172
6,909	30,759	20%	6,152
7,409	32,985	30%	9,895
7,809	34,765	25%	8,691
8,587	38,228	10%	3,823
		100%	$32,733

Notes:

1. This example of an expected cash flow analysis is not meant to conform to the definition of expected variability in Subtopic 810-10's glossary. To conform to that definition, this analysis would need to include variability in cash flows from the potential fair value of the aircraft at the end of the five years (see Example 10.2.30).
2. Present value is based on a five-year annuity of the amount in Column A, discounted at a risk-free rate of 4%.

3. This example assumes that for each annual cash flow scenario, the same cash flow will occur in each of the five years.

Example 10.2.20

Step 2: Calculating expected losses and expected residual returns from operations

The following table illustrates how expected losses (negative variability) and expected residual returns (positive variability) are calculated based on the facts in Example 10.2.10 involving the operations of an aircraft over a five years (see Table 1).

Table 2
Cash flows from aircraft operations
($'000s)

A	B[1]	C	D[2]	E = B - D	F = C × E	G = C × E
Estimated annual cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows	Positive (negative) differences	Expected losses	Expected residual returns
$6,247	$27,812	15%	$32,733	$(4,921)	$ (738)	
6,909	30,759	20%	32,733	(1,974)	(395)	
7,409	32,985	30%	32,733	252		$ 75
7,809	34,765	25%	32,733	2,032		508
8,587	38,228	10%	32,733	5,495		550
		100%			$(1,133)	$1,133

Notes:

1. Present value is based on a five-year annuity of the amount in Column A discounted at a risk-free rate of 4%.
2. Total from Example 10.2.10, Table 1, Column D.

Example 10.2.30

Step 3: Calculating expected losses and expected residual returns

To illustrate the components of a legal entity's expected losses and expected residual returns, this example builds on Examples 10.2.10 and 10.2.20. It also considers the present value of the expected cash flow from the sale of the aircraft, which is a component of entity-wide expected losses and expected residual returns.

Description of the arrangement

The following additional facts are relevant.

- Legal Entity is an LLC formed to invest in a business jet, which has a fair value of $80 million. Legal Entity plans to operate the aircraft for five years and then sell it.
- Legal Entity has two members (a passive member and a managing member) who together contribute $16 million in cash. $16 million is the fair value of the equity at risk.
  - The managing member contributes $7.51 million and receives a carried interest of 2%.
  - The passive member contributes $8.49 million and receives a carried interest of 98%.
- Legal Entity's governing provisions make it the functional equivalent of a limited partnership and its passive member lacks substantive kick-out rights or participating rights. Therefore, its passive member lacks the power to direct the activities that most significantly impact its economic performance, making Legal Entity a VIE.
- A single independent lender (Aircraft Lender) provides financing for the remainder of the acquisition price of the aircraft ($64 million). The debt is recourse only to the aircraft and the interest rate on the debt is 5.5% per annum.
- Legal Entity obtains a guarantee from an independent third-party residual value guarantor (Aircraft Guarantor) that the value of the aircraft will be at least $51.22 million at the end of five years. An annual guarantee fee of $456,000 is payable to Aircraft Guarantor by Legal Entity over the five-year period of the guarantee.
- Legal Entity's members share in proportion to their respective carried ownership percentages:
  - the net income or losses; and
  - any capital appreciation or depreciation on the aircraft.
- The managing member earns a series of fees for services provided to Legal Entity, including management of the aircraft and general management of Legal Entity and all of its affairs. These fees are set at 43% of net income before paying managing member's fees and the guarantee fees. The fees paid to the managing member are considered a variable interest because the arrangement includes terms not customarily present in arrangements for similar services negotiated at arm's length.
- Legal Entity expects to sell the aircraft at the end of five years, use the proceeds to repay the debt, and distribute the remaining proceeds to the members.
- For simplicity, this example assumes that the risk-free rate and credit-adjusted risk-free rate are both 4%.

Calculating expected losses and expected residual returns

Table 2 in Example 10.2.20 presents Legal Entity's expected cash flows from operations (excluding variable interests) during its five-year operating term. Estimated cash flows from operations have not been reduced to reflect:

— fees paid to the managing member: 43% of net income before payment of the managing member's fees and guarantee fees;
— fees paid to Aircraft Guarantor: $456,000 per year; or
— interest payments to Aircraft Lender: $3.52 million per year.

All of those items pertain to variable interests in Legal Entity (see chapter 3).

— Fees paid to Aircraft Guarantor will reduce net income but will increase the cash flows from disposition of the aircraft (reducing the variability in overall cash flows of the entity). Therefore, they are excluded from the entity-level calculation of expected cash flows so that the variability inherent in Legal Entity's assets (excluding the guarantee) can be determined.

— Fees to the managing member reduce variability in overall cash flows of Legal Entity because they are determined as a percentage of net income before payment of the fees.

— Debt to Aircraft Lender is also a variable interest in Legal Entity, and therefore interest payments to Aircraft Lender are excluded from the calculation of variability in cash flows from operations.

Table 2 from Example 10.2.20 is reproduced here for convenience.

Table 2
Cash flows from aircraft operations[1]
($'000s)

A	B[2]	C	D[3]	E = B - D	F = C × E	G = C × E
Estimated annual cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows	Positive (negative) differences	Expected losses	Expected residual returns
$6,247	$27,812	15%	$32,733	$(4,921)	$ (738)	
6,909	30,759	20%	32,733	(1,974)	(395)	
7,409	32,985	30%	32,733	252		$ 75
7,809	34,765	25%	32,733	2,032		508
8,587	38,228	10%	32,733	5,495		550
		100%			$(1,133)	$1,133

Notes:

1. The cash basis net income in this table excludes fees paid to the managing member, annual interest payments and guarantee fees because those amounts are paid to the variable interest holders.
2. Present value is based on a five-year annuity of the amount in Column A discounted at a risk-free rate of 4%.
3. Total from Example 10.2.10, Table 1, Column D.

Table 3 presents Legal Entity's expected cash flows from the sale of the aircraft at the end of Legal Entity's five-year operating term. The variability in those cash flows must be considered together with the variability in cash flows from operations (excluding variable interests) to determine the variability in the fair value of Legal Entity's net assets (excluding variable interests).

Proceeds from the sale of the aircraft exclude amounts paid under the residual value guarantee, which is a variable interest (see fact pattern).

Table 3
Cash flows from sale of aircraft
($'000s)

A	B[1]	C	D[2]	E = B - D	F = C × E	G = C × E
Estimated cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows	Positive (negative) differences	Expected losses	Expected residual returns
$34,760	$28,570	15%	$47,267	$(18,697)	$(2,805)	
52,185	42,892	20%	47,267	(4,375)	(875)	
60,935	50,084	30%	47,267	2,817		$ 845
65,935	54,193	25%	47,267	6,926		1,731
70,935	58,303	10%	47,267	11,036		1,104
		100%			$(3,680)	$3,680

Notes:

1. The amount in Column A received at the end of five years discounted at a risk-free rate of 4%.
2. Present value of expected cash flows is the sum of each of the present values of estimated cash flows (column B) after being multiplied by their respective probability of occurrence (column C). Example 10.2.10, Table 1, illustrates this calculation for the cash flows from aircraft operations.

Table 4 combines the present value of the expected cash flows from operations and the sale of the aircraft. The expected cash flows related to Legal Entity's net income or loss (excluding variable interests) and the fair value of the net assets (excluding variable interests) should be considered in the aggregate to determine Legal Entity's expected losses and expected residual returns.

Table 4
Summary of expected losses and residual returns
($'000s)

	Expected losses	Expected residual returns
Expected variability in cash flows from operations (from Table 2)	$(1,133)	$1,133
Expected variability in terminal value of assets (from Table 3)	(3,680)	3,680
Total expected losses and expected residual returns	$(4,813)	$4,813

Table 5 reconciles the expected cash flows presented above to the fair value of Legal Entity's only asset (the aircraft).

Table 5 Reconciliation of expected cash flows to fair value of Legal Entity's assets ($'000s)	
Expected cash flows from:	
Operations (from Table 2)	$32,733
Disposition of aircraft (from Table 3)	47,267
Total fair value of assets[1]	$80,000

Note:
1. This example assumes the fair value of assets is easily derived from discounting the cash flows at a risk-free rate. In other situations, the reconciliation may be more challenging (see Question 10.2.110).

Analyzing sufficiency of Legal Entity's equity at risk

Based on these calculations, the level of equity Legal Entity needs to demonstrate that its equity is sufficient to finance its own operations is any amount greater than $4.813 million.

The 10% presumption in paragraph 810-10-25-45 means that Legal Entity needs equity of at least $8 million (based on assets of $80 million). However, that presumption is overcome because Legal Entity's expected losses are less than 10% of its assets (see section 4.3.40). Legal Entity's equity at risk has a fair value of $16 million, which is far greater than the $4.813 needed to demonstrate the sufficiency of the equity.

Nevertheless, Legal Entity is a VIE because its passive member lacks the power, through voting or similar rights, to direct the activities that most significantly impact its economic performance (see 'description of the arrangement').

Note: If Legal Entity's equity at risk had a fair value of less than $4,813, Legal Entity would not have sufficient equity at risk unless it was able to demonstrate that it:

- could finance its activities without additional subordinated financial support; or
- had at least as much equity invested as other similar entities that operate with no additional subordinated financial support (see section 4.3.40).

Question 10.2.120
How are interests in specified assets considered when calculating expected losses and residual returns?

Interpretive response: Any expected losses and expected residual returns from interests in specified assets are excluded from the entity-wide expected losses and expected residual returns. This is because interests in specified assets are not considered variable interests in the legal entity itself (see section 3.6). An interest in specified assets of a legal entity exists if: [810-10-25-55 – 55-56]

- the fair value of the specified assets is 50% or less of the fair value of the legal entity's total assets; and
- the holder has only an insignificant other variable interest in the legal entity.

Example 10.2.40

Calculating total expected losses and expected residual returns when interests in specified assets exist

To illustrate the effects of the guidance on interests in specified assets on the calculation of expected losses and expected residual returns, the following example builds on Examples 10.2.10 to 10.2.30.

Description of the arrangement

In addition to the assumptions in Example 10.2.30 about expected losses and expected residual returns in Legal Entity (operating as an LLC and formed to invest in a business jet), the following facts are relevant.

- Legal Entity acquires an aircraft hangar in which to house its aircraft. The hangar has room for the aircraft and nine other planes. Legal Entity plans to lease the hangar to tenants for five years and then sell it. The aircraft hangar has a fair value of $5 million.
- In addition to the $16 million in cash contributed by the two members, the purchase price of the hangar is funded by:
  - equity contributions from the members of $1 million in cash (provided in proportion to the members' respective carried interests); and
  - general recourse financing (with the hangar provided as collateral) from a single independent lender (Hangar Lender) of $4 million with an interest rate of 4% per annum.
- Legal Entity leases the hangar to an aircraft maintenance company (Hangar Guarantor) that provides a residual value guarantee on the hangar's residual value.
  - The lease to Hangar Guarantor is for five years for a fixed rental, and Legal Entity takes back a sublease for 10% of the hangar space for the same period.
  - Hangar Guarantor guarantees that the hangar's residual value will be at least $4.624 million at the end of five years and is given a purchase option to acquire the hangar for that amount at the end of five years.
- Members of Legal Entity share the net income or losses from managing the hangar in proportion to their respective capital ownership percentages. The managing member does not receive a fee in connection with the operations of the hangar.

— Legal Entity expects to sell the hangar at the end of five years, use the proceeds to repay the debt, and distribute the remaining proceeds to the members.

Calculating expected losses and expected residual returns

The cash flows used to determine Legal Entity's expected losses and expected residual returns are based on the cash flows that represent the fair value of Legal Entity's net assets. Therefore, those cash flows exclude interest expense on any debt that represents a variable interest in Legal Entity. Because the debt to finance the hangar's acquisition is general recourse debt, it represents a variable interest in Legal Entity instead of an interest in specified assets. As a result, the annual interest payments of $160,000 on the debt do not reduce the estimated cash flows.

Table 6 presents Legal Entity's expected cash flows from managing the hangar's operations during the five-year operating lease term.

Table 6
Cash flows from hangar lease
($'000s)

A	B[1]	C	D[2]	E = B - D	F = C × E	G = C × E
Estimated annual cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows	Positive (negative) differences	Expected losses	Expected residual returns
$250	$1,113	15%	$1,200	$(87)	$(13)	
260	1,157	20%	1,200	(43)	(8)	
270	1,202	30%	1,200	2		$ –
280	1,247	25%	1,200	47		12
290	1,291	10%	1,200	91		9
		100%			$(21)	$21

Notes:

1. Present value is based on a five-year annuity of the amount in Column A discounted at a risk-free rate of 4%.
2. Present value of expected cash flows is the sum of each of the present values of estimated cash flows (column B) after being multiplied by their respective probability of occurrence (column C). Example 10.2.10, Table 1, illustrates this calculation for the cash flows from aircraft operations.

Table 7 presents Legal Entity's expected cash flows from the sale of the hangar at the end of the five-year lease term.

Table 7
Cash flows from sale of hangar
($'000s)

A	B[1]	C	D[2]	E = B - D	F = C × E	G = C × E
Estimated cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows	Positive (negative) differences	Expected losses	Expected residual returns
$4,100	$3,370	15%	$3,800	$(430)	$(65)	
4,400	3,616	20%	3,800	(184)	(37)	
4,650	3,822	30%	3,800	22		$ 7
4,875	4,007	25%	3,800	207		52
5,150	4,233	10%	3,800	433		43
		100%			$(102)	$102

Notes:

1. Present value is the amount in Column A received at the end of five years discounted at a risk-free rate of 4%.
2. Present value of expected cash flows is the sum of each of the present values of estimated cash flows (column B) multiplied by their respective probability of occurrence (column C). Example 10.2.10, Table 1, illustrates this calculation for the cash flows from aircraft operations.

Table 8 presents expected cash outflows associated with the hangar guarantee obligation.

Table 8
Expected cash flows of hangar guarantee obligation
($'000s)

A	B[1]	C	D = B × C
Estimated cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows
$(524)	$(430)	15%	$(65)
(224)	(184)	20%	(37)
–	–	65%	–
		100%	$(102)

Note:

1. Present value is the amount in Column A received at the end of five years discounted at a risk-free rate of 4%.

Table 9 presents expected cash flows associated with the hangar purchase option.

Table 9
Expected cash flows of hangar purchase option
($'000s)

A	B[1]	C	D = B × C
Estimated cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows
$26	$22	30%	$ 7
251	207	25%	52
526	433	10%	43
–	–	35%	–
		100%	$102

Note:

1. Present value is the amount in Column A received at the end of five years discounted at a risk-free rate of 4%.

Determining whether residual value guarantee and purchase option are variable interests

The fair value of the hangar is less than 50% of the fair value of Legal Entity's total assets ($5 million ÷ $85 million = 6%). Therefore, the residual value guarantee and purchase option related to the hangar represent interests in specified assets instead of variable interests in Legal Entity. The residual value guarantee absorbs all of the expected losses from the disposition of the hangar (see Table 8), and the purchase option receives the right to all of the expected residual returns from the disposition of the hangar (see Table 9).

For simplicity, this example assumes there is no credit risk related to the guarantee and therefore none of the expected losses contractually absorbed by the guarantor are reflected as expected losses of Legal Entity. However, generally a legal entity retains some of the credit risk associated with such a guarantee.

Table 10 presents Legal Entity's expected cash flows from disposition of the hangar, including the interests in specified assets – i.e. the residual value guarantee and the purchase option.

Table 10
Cash flows from sale of hangar, excluding interests in specified assets ($'000s)

A[1]	B[2]	C	D[3]	E = B - D	F = C × E	G = C × E
Estimated cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows	Positive (negative) differences	Expected losses	Expected residual returns
$4,624	$3,800	15%	$3,800	$ –	$ –	$ –
4,624	3,800	20%	3,800	–	–	–
4,624	3,800	30%	3,800	–	–	–
4,624	3,800	25%	3,800	–	–	–
4,624	3,800	10%	3,800	–	–	–
		100%			$ –	$ –

Notes:

1. This amount is constant because of the residual value guarantee and purchase option.
2. Present value is the amount in Column A received at the end of five years discounted at a risk-free rate of 4%.
3. Present value of expected cash flows is the sum of each of the present values of estimated cash flows (column B) multiplied by their respective probability of occurrence (column C). Example 10.2.10, Table 1, illustrates this calculation for the cash flows from aircraft operations.

Table 11 summarizes the components of Legal Entity's expected losses and expected residual returns inclusive of the interests in specified assets.

Table 11
Summary of expected losses and residual returns ($'000s)

	Expected losses	Expected residual returns
Expected losses and residual returns from aircraft (from Table 4)	$(4,813)	$4,813
Expected variability in hangar net income or loss (from Table 6)	(21)	21
Expected variability in fair value of assets (from Table 10)	–	–
Total expected losses and expected residual returns	$(4,834)	$4,834

The expected cash flows related to Legal Entity's net income or loss (excluding variable interests) and the fair value of its net assets (excluding variable interests) are considered in the aggregate to determine Legal Entity's expected losses and expected residual returns.

Table 12 reconciles the expected cash flows to the fair value of Legal Entity's only assets (the aircraft and the hangar).

Table 12
Reconciliation of expected cash flows to fair value of Legal Entity's assets ($'000s)

Expected cash flows from:	
Net income or loss – aircraft (from Example 10.2.30, Table 2)	$32,733
Net income or loss – hangar (from Table 6)	1,200
Disposition of aircraft (from Example 10.2.30, Table 3)	47,267
Disposition of hangar (from Table 7)	3,800
Total fair value of assets[1]	$85,000

Note:

1. This example assumes the fair value of assets is easily derived from discounting the cash flows at a risk-free rate. In other situations, the reconciliation may be more challenging (see Question 10.2.110).

Analyzing sufficiency of Legal Entity's equity at risk

Based on the calculations summarized in Table 11, the level of equity Legal Entity needs to demonstrate that its equity is sufficient to finance its own operations is any amount greater than $4.834 million. The 10% presumption in paragraph 810-10-25-45 would indicate that the entity needs equity of at least $8.5 million (based on assets of $85 million). However, that presumption is overcome because Legal Entity's expected losses are less than 10% of its assets (see section 4.3.40).

Legal Entity's equity at risk has a fair value of $17 million (comprised of $16 million of cash equity contributed by the members for the aircraft purchase and $1 million contributed for the hangar purchase), which is far greater than the $4.834 million needed to demonstrate the sufficiency of the equity.

Nevertheless, Legal Entity is a VIE because its passive member lacks the power, through voting rights or similar rights, to direct the activities that most significantly impact its economic performance (see fact pattern in Example 10.2.30).

10.2.30 FASB examples of calculation of expected losses and expected residual returns

The two FASB examples reproduced below illustrate the following calculations:

— expected losses and expected residual returns using the expected cash flow approach (Example 1); and

— expected losses and expected residual returns for a legal entity that has no history of net losses and expects continued profitability (Example 2) (see Question 10.2.90).

Excerpt from ASC 810-10

Variable Interest Entities

> Illustrations

>> Example 1: Expected Losses, Expected Residual Returns, and Expected Variability

55-42 This Example illustrates a computation of **expected losses**, **expected residual returns**, and **expected variability** and is intended to explain the meaning of those terms. Entities will not necessarily be able to estimate probabilities to use a precise computation of the type illustrated, but they should use their best efforts to achieve the objective described. This Example is based on a hypothetical pool of financial assets with total contractual cash flows of $1 billion and has the following assumptions:

a. A single party holds all of the beneficial interests in the VIE, and the VIE has no liabilities.
b. There is no decision maker because the VIE's activities are completely predetermined.
c. All cash flows are expected to occur in one year or not to occur at all.
d. The appropriate discount rate (the interest rate on risk-free investments) is 5 percent.
e. No other factors affect the fair value of the assets. Thus, the present value of the expected cash flows from the pool of financial assets is assumed to be equal to the fair value of the assets.

55-43 This Example uses a simple situation intended to illustrate the concepts of expected losses, expected residual returns, and expected variability. Since it is assumed that there is only one party involved, the identity of the primary beneficiary is obvious.

55-44 The following table shows the computation of expected cash flows using the cash flow possibilities that the variable interest holder has identified. The items to be included in expected cash flows of a VIE are described in the definition of the terms **expected losses**, **expected residual returns**, and **expected variability**.

(Amounts in Thousands)

Estimated Cash Flows	Probability	Expected Cash Flows	Fair Value
$ 650,000	5.0%	$ 32,500	$ 30,952
700,000	10.0	70,000	66,667
750,000	25.0	187,500	178,571
800,000	25.0	200,000	190,477
850,000	20.0	170,000	161,905
900,000	15.0	135,000	128,571
	100.0%	$ 795,000	$ 757,143

55-45 The expected cash flows are $795,000, and the fair value of the pool of assets is $757,143.

55-46 The following table shows how expected losses are computed once the expected cash flows are determined. Estimated cash flows (possible outcomes) are compared with the computed expected cash flows (probability-weighted outcomes). Estimated cash flows that are less than the expected cash flows contribute to expected losses, and cash flow possibilities that exceed the expected cash flows contribute to expected residual returns.

(Amounts in Thousands)

Estimated Cash Flows[(a)]	Expected Cash Flows	Difference Estimated (Losses) Residual Returns	Probability	Expected Losses Based on Expected Cash Flows	Expected Losses Based on Fair Value
$ 650,000	$ 795,000	$ (145,000)	5.0%	$ (7,250)	$ (6,905)
700,000	795,000	(95,000)	10.0	(9,500)	(9,048)
750,000	795,000	(45,000)	25.0	(11,250)	(10,714)
800,000	795,000	5,000	25.0		
850,000	795,000	55,000	20.0		
900,000	795,000	105,000	15.0		
			100.0%	$ (28,000)	$ (26,667)

(a) The computation in this Example uses the probability times the difference between the estimated cash flows and expected cash flows and then discounts the result to arrive at fair value. The same result can be achieved by using the probability times the difference between the present value of the estimated cash flows and the fair value. In situations in which the timing of the cash flows varies, that alternate from may be easier to use.

55-47 The term *expected losses* refers to the expected losses based on fair value (using fair value as the benchmark), which in this Example is $26.667 million.

55-48 The following table shows how expected residual returns are computed for the same pool of assets.

(Amounts in Thousands)

Estimated Cash Flows	Expected Cash Flows	Difference Estimated (Losses) Residual Returns	Probability	Expected Residual Return Based on Expected Cash Flows	Expected Residual Return Based on Fair Value
$ 650,000	$ 795,000	$ (145,000)	5.0%		
700,000	795,000	(95,000)	10.0		
750,000	795,000	(45,000)	25.0		
800,000	795,000	5,000	25.0	$ 1,250	$ 1,191
850,000	795,000	55,000	20.0	11,000	10,476
900,000	795,000	105,000	15.0	15,750	15,000
			100.0%	$ 28,000	$ 26,667

55-49 The term *expected residual returns* refers to the expected residual returns based on fair value (using fair value as the benchmark), which in this Example is $26.667 million. Expected variability is a measure of total variability in either direction. It is the sum of the absolute values of the expected losses and expected residual returns.

>> Example 2: Calculation of Expected Losses if There Is No History of, nor Future Expectation of, Net Losses

55-50 This Example illustrates the calculation of expected losses if a legal entity has no history of net losses and expects continued profitability. This Example has the following assumptions:

…

b. On the same day, Entity B enters into a five-year-market-rate lease for the building from Entity A that includes a guarantee of a portion of the building's residual value. The sum of the present value of the **lease payments** and the residual value guarantee is less than substantially all the fair value of the building.

…

55-51 The estimated annual outcomes in the Example include both estimated cash flows and the estimated fair value of Entity A's assets to be distributed to variable interest holders in lieu of cash, exclusive of cash flows (or flows of other assets) to and from variable interests. The guarantee is a variable interest in Entity A because it is an interest in assets with a fair value that is more than half of the total fair value of Entity A's assets. Therefore, losses absorbed by the residual value guarantee are losses of Entity A and are included in the outcomes used to calculate expected losses. For calculation simplicity, the estimated outcomes, which include both cash flows and changes in the fair value of Entity A's net assets, and related probabilities are assumed to be the same each year of the five-year lease, and at the end of the lease, the carrying value of the building is assumed to be its fair value.

55-52 The following table shows the January 1, 2004, calculation of the expected outcome at the inception of the guarantee identified as a variable interest. The fair value of the expected outcome is assumed to be equal to the sum of the present values of probability-weighted estimated annual outcomes for the five-year lease term, excluding the effects of the residual value guarantee. Any variation in estimated outcomes, as compared to the expected outcome, represents a change to the value of Entity A's net assets exclusive of variable interests from the calculation-date value of those net assets.

(Amounts in Thousands)

Estimated Annual Outcomes[(a)]	Probability	Expected Annual Outcome	Fair Value of Expected Five-Year Outcomes[(b)]
$ (10,000)	5.0%	$ (500)	$ (2,165)
(5,000)	10.0	(500)	(2,165)
–	20.0	–	–
10,000	50.0	5,000	21,648
50,000	15.0	7,500	32,471
	100.0%	$ 11,500	$ 49,789

(a) Estimated outcomes include both estimated cash flows, exclusive of cash flows (or flows of other assets) to and from variable interests, and the estimated fair value of Entity A's assets to be distributed to variable interest holders in lieu of cash.

(b) The fair value is assumed to be the sum of the present values of the expected outcomes for each year of the five-year period. Because of the simplifying assumption that the annual estimated outcomes and probabilities are the same for each year of the five-year period, the expected annual outcomes are treated as level annuities in the present value calculations to determine the fair value of the five-year expected outcomes.

55-53 The following table shows the calculation of expected losses as the negative variability from the fair value of the expected outcome. Note that the estimated annual outcomes of $0 and $10,000 contribute to expected losses although neither amount is negative. To the extent that an estimated outcome, although positive, is less than the expected outcome, the legal entity will lose value in relation to its value based on the expected outcome. The following table illustrates the calculation of this expected loss as the fair value of the probability-weighted negative variations from the expected outcome. Expected losses include all such negative variations.

(Amounts in Thousands)

Estimated Annual Outcomes	Present value of Estimated Five-Year Outcomes[(a)]	Fair Value of Expected Five-Year Outcomes (from the table in the preceding paragraph)	Positive (Negative) Variation from Expected Value	Probability	Expected Losses	Residual Returns
$ (10,000)	$ (43,294)	$ 49,789	$ (93,083)	5.0%	$ (4,654)	
(5,000)	(21,648)	49,789	(71,437)	10.0	(7,144)	
–	–	49,789	(49,789)	20.0	(9,958)	
10,000	43,294	49,789	(6,495)	50.0	(3,247)	
50,000	216,473	49,789	166,684	15.0	–	$ 25,003
				100.0%	$ (25,003)	$ 25,003

(a) Because of the simplifying assumption that the annual estimated outcomes are the same for each year of the five-year period, the estimated annual outcomes are treated as level annuities in the calculation of the present value of estimated five-year outcomes.

55-54 Negative variations can occur without having a net loss reflected in any of the estimated outcomes. Consequently, a profitable VIE will have expected losses which must be considered in evaluating the sufficiency of equity-at-risk under paragraph 810-10-25-45(c).

10.3 Allocating expected losses and expected residual returns to variable interests

In applying the VIE consolidation model, it may be necessary to determine the allocation of a legal entity's expected losses and expected residual returns to the entity's interest holders. For example, this may be necessary to determine:

— if the equity-at-risk group is obligated to absorb expected losses (see section 4.5); [810-10-15-14(b)(2)]
— if any individual equity investor's voting rights and economic interests in the legal entity are disproportionate (see section 4.7); and [810-10-15-14(c)]
— the legal entity's primary beneficiary (see chapter 6). [810-10-25-38A]

Question 10.3.10
How are expected losses and expected residual returns allocated?

Interpretive response: To allocate a legal entity's expected losses and expected residual returns, an enterprise considers the rights and obligations that a variable interest conveys to its holder in relation to the variable interests of other parties.

In our experience, there are two primary methods of performing this allocation: the bottom-up approach and the top-down approach. The appropriate methodology depends on the nature of the transaction structure and the way in which cash flows of the legal entity are shared among its variable interest holders. However, we believe the methodology used to perform these allocations should be applied consistently by a reporting enterprise to comparable transaction structures.

Bottom-up approach

In relatively straightforward transaction structures, an acceptable allocation methodology may entail determining how:

— expected losses, if incurred as an actual loss, would be absorbed by the parties involved with the legal entity; and
— expected residual returns, if realized as an actual return, would be received by the parties involved with the legal entity.

Under this approach, the legal entity's expected losses and expected residual returns may not be allocated to all of its variable interest holders. For example, when a legal entity has issued debt, but its expected losses do not exceed the fair value of its equity at risk, none of the expected losses are allocated to the investors in its debt. [810-10-55-24]

We believe this approach is consistent with how Subtopic 810-10 contemplates allocating expected losses and residual returns because it includes a similar example in its implementation guidance.

Top-down approach

Because of complexities inherent in the transaction structure or pattern of cash flow distribution to the variable interest holders, it often may be necessary to determine the variability in the fair value of each variable interest holder's interest to allocate the entity-level expected losses and expected residual returns to variable interest holders.

For example, we believe a top-down approach to allocate an entity's expected losses and expected residual returns is necessary when:

— cash flows are separated into interest-only and principal-only strips; or
— an interest such as nonrecourse debt causes the cash flows not to be shared in a consecutive fashion or in proportion to the stated interests of investors.

Under this approach, an entity's expected losses and expected residual returns are allocated to all of the entity's variable interest holders.

The sum of the variability in the fair value of all of an entity's variable interest holders' interests will usually be greater than the entity-level variability. Therefore, in applying the top-down approach it is usually necessary to allocate or reconcile the difference between the total variability in the individual variable interests to the entity-level variability.

Although there is more than one methodology that could be used to reconcile the variability in the individual variable interests to that of the entity as a whole, we believe that one appropriate methodology is the proportionate variability methodology. Under this methodology, each variable interest holder's share of the entity-level variability in cash flows is determined as the ratio of the variability in the individual variable interest holder's cash flows divided by the total variability in all variable interest holders' cash flows. The proportionate variability allocation approach is illustrated in Example 10.3.10, which builds on Examples 10.2.10 to 10.2.40.

Example 10.3.10
Proportionate variability approach to allocating variability

Based on the information provided in Examples 10.2.10 to 10.2.40, Tables 18-22 present the allocation of expected losses and expected residual returns of Legal Entity among all of its variable interest holders using the proportionate variability methodology.

To perform the allocation presented in Tables 18-22, it is first necessary to determine the variability in cash flows to be received or paid by the managing member (decision-maker), Aircraft Lender, Hangar Lenders and Aircraft Guarantor.

Table 13 presents expected cash flows associated with fees paid to the managing member (decision-maker) during Legal Entity's five-year operating term. For simplicity, cash flows are assumed to occur in equal amounts each year during the five-year period under each estimated cash flow scenario. In a typical situation the cash flows would vary from one year to the next under all scenarios.

Table 13
Fees paid to managing member
($'000s)

A[1]	B[2]	C	D = B × C
Estimated annual cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows
$1,173	$5,220	15%	$ 783
1,457	6,488	20%	1,298
1,672	7,445	30%	2,233
1,844	8,211	25%	2,053
2,179	9,700	10%	970
		100%	$7,337

Notes:

1. The fees paid to the managing member are 43% of cash basis net income excluding hangar operations and before payment of the managing member's fees and guarantee fees.

   Example 10.2.30, Table 2, Column A, presents cash basis net income excluding hangar operations and fees paid to the managing member, annual interest payments on $64 million ($3.52 million per year), and guarantee fees ($456,000 per year).

   Therefore, the managing member fees are calculated by subtracting $3.52 million from each of the amounts in Example 10.2.30, Table 2, Column A, and multiplying each sum by 43% – e.g. ($6,247 - $3,520) × 43% = $1,173.
2. Present value is based on a five-year annuity of the amount in Column A discounted at a risk-free rate of 4%.

Table 14 presents expected cash flows associated with fixed fees paid to Aircraft Guarantor.

Table 14
Fees paid to Aircraft Guarantor
($'000s)

A	B[1]	C	D = B × C
Estimated annual cash flows	Present value of estimated cash flows	Probability of occurrence	Present value of expected cash flows
$456	$2,029	100%	$2,029

Note:

1. Present value is based on a five-year annuity of the amount in Column A discounted at a risk-free rate of 4%.

Table 15 presents the expected cash flows of Aircraft Lender. The present value of the total contractual cash flows to be received by Aircraft Lender, when discounted at the risk-free rate of 4%, exceeds the $64 million principal balance of the loan. This is because the loan has an interest rate of 5.5% per annum. This reflects the lender's expectation that it will not receive all of the cash flows due under the loan in all circumstances.

Table 15
Expected cash flows of Aircraft Lender
($'000s)

Probability of occurrence	Estimated cash flows		Present value of estimated cash flows		
	Interest[2]	Principal[3]	Interest[4]	Principal[5]	Total
15%	$17,600	$51,220	$15,670	$42,099	$57,769
20%	17,600	52,185	15,670	42,892	58,562
30%	17,600	60,935	15,670	50,084	65,754
25%	17,600	64,000	15,670	52,604	68,274
10%	17,600	64,000	15,670	52,604	68,274
100%					
Expected cash flows[1]					$64,000

Notes:

1. The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example 10.2.10, Table 1 based on a different stream of estimated cash flows.
2. The operating cash flows generated by the aircraft as indicated in Example 10.2.30, Table 2 are sufficient to make the interest payments to Aircraft Lender of $3.52 million per year ($17.6 million = $3.52 million × 5 years) under all cash flow scenarios.
3. The cash flows for repayment of the $64 million principal balance on the loan payable to Aircraft Lender will come from the disposition of the aircraft and the aircraft residual value guarantee. As indicated in Example 10.2.30, Table 3, the

cash flows from disposition of the aircraft are not sufficient in every cash flow scenario to repay the principal on the loan.

In the first cash flow scenario, Aircraft Lender will receive the proceeds of the guarantee, increasing the cash flow that it otherwise would have received from the disposition of the aircraft by \$16.46 million to \$51.22 million: \$34.76 million (see Example 10.2.30, Table 3, column A) + \$16.46 million = \$51.22 million.

In the second and third cash flow scenarios, Aircraft Lender will receive only the cash flows from disposition of the aircraft of \$52.185 million and \$60.935 million, respectively. In the fourth and fifth cash flow scenarios, the disposition cash flows paid to Aircraft Lender will be limited to the \$64 million principal amount due.

4. Present value of interest cash flows is based on a five-year annuity of \$3.52 million (\$17.6 million = \$3.52 million × 5 years) discounted at a risk-free rate of 4%.
5. Present value of principal cash flows is based on the present value of estimated principal cash flows to be received at the end of five years discounted at a risk-free rate of 4%.

Table 16 presents the expected cash flows of Hangar Lender. The present value of the total contractual cash flows to be received by Hangar Lender, when discounted at the risk-free rate of 4%, equals the \$4 million principal balance of the loan because the loan has an interest rate equal to the risk-free rate. This reflects Hangar Lender's expectation that it will receive all of the cash flows due under the loan in all circumstances.

Table 16
Expected cash flows of Hangar Lender
(\$'000s)

Probability of occurrence	Estimated cash flows		Present value of estimated cash flows		
	Interest[2]	Principal[3]	Interest[4]	Principal[5]	Total
15%	\$800	\$4,000	\$712	\$3,288	\$4,000
20%	800	4,000	712	3,288	4,000
30%	800	4,000	712	3,288	4,000
25%	800	4,000	712	3,288	4,000
10%	800	4,000	712	3,288	4,000
100%					
Expected cash flows[1]					\$4,000

Notes:

1. The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example 10.2.10, Table 1 based on a different stream of estimated cash flows.
2. The operating cash flows generated by the hangar as indicated in Example 10.2.40, Table 6 are sufficient to make the interest payments to the hangar lender of \$160,000 per year (\$800,000 = \$160,000 × 5 years) under all cash flow scenarios.
3. The cash flows for repayment of the \$4 million principal balance on the loan payable to Hangar Lender will come from the disposition of the hangar and the hangar residual value guarantee. As indicated in Example 10.2.40, Table 7, the

cash flows from disposition of the hangar are sufficient in every cash flow scenario to repay the principal on the loan.

4. Present value of interest cash flows is based on a five-year annuity of \$160,000 (\$800,000 = \$160,000 × 5 years) discounted at a risk-free rate of 4%.
5. Present value of principal cash flows is based on the present value of estimated principal cash flows to be received at the end of five years discounted at a risk-free rate of 4%.

Table 17 presents the combined cash flows of Legal Entity from the operations and disposition of the aircraft and hangar.

Table 17
Estimated cash flows of Legal Entity
(\$'000s)

A[1]	B[2]	C	D = A - C	E = B × D	F = B × D
Present value of estimated cash flows	Probability of occurrence	Present value of estimated cash flows	Positive (negative) differences	Expected losses	Expected residual returns
\$61,295	15%	\$85,000	\$(23,705)	\$(3,556)	
78,608	20%	85,000	(6,392)	(1,278)	
88,071	30%	85,000	3,701		\$ 921
94,005	25%	85,000	9,005		2,251
101,622	10%	85,000	16,622		1,662
	100%			\$(4,834)	\$4,834

Notes:

1. The sum of the present value amounts in Example 10.2.30, Tables 2 and 3, and in Example 10.2.40, Tables 6 and 10.
2. From Example 10.2.30, Tables 2 and 3, and Example 10.2.40, Tables 6 and 10.
3. The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example 10.2.10, Table 1 based on a different stream of estimated cash flows.

Table 18 presents each variable interest holder's share of the expected cash flows presented in Table 17. This information is the basis for determining the variability of each variable interest holder.

Table 18
Participation by variable interest holders in estimated cash flows of Legal Entity
(\$'000s)

Probability of occurrence	PV of cash flows of individual variable interest holders				Total PV of estimated cash flows6
	Aircraft Lender[2]	Hangar Lender[3]	Legal Entity members[4]	Aircraft Guarantor[5]	
15%	\$57,769	\$4,000	\$11,026	\$(11,500)	\$ 61,295
20%	58,562	4,000	14,017	2,029	78,608
30%	65,754	4,000	16,288	2,029	88,071

Table 18
Participation by variable interest holders in estimated cash flows of Legal Entity ($'000s)

Probability of occurrence	PV of cash flows of individual variable interest holders				Total PV of estimated cash flows6
	Aircraft Lender[2]	Hangar Lender[3]	Legal Entity members[4]	Aircraft Guarantor[5]	
25%	68,274	4,000	19,702	2,029	94,005
10%	68,274	4,000	27,319	2,029	101,622
100%					
Expected cash flows[1]	$64,000	$4,000	$17,000	$ –	$ 85,000

Notes:
1. The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example 10.2.10, Table 1 based on a different stream of estimated cash flows.
2. From Table 15.
3. From Table 16.
4. The members receive all cash flows not paid to other variable interest holders. This includes the fees paid to the managing member as presented in Table 13. Therefore, the amounts in this column represent the residual cash flows of Legal Entity necessary to reconcile to the total present value of estimated cash flows to be received by Legal Entity, which are presented in Table 17.
5. As indicated in Table 14, the present value of Aircraft Guarantor's annual fee is $2.029 million. Further, because the guarantee is triggered if the value of the aircraft is less than $51.22 million at disposition, there is a 15% chance that Aircraft Guarantor will be required to pay $16.46 million: $51.22 million - $34.76 million (see Example 10.2.30, Table 3, column A) = $16.46 million. The net amount of $13.529 (the present value of $16.46 million) million subtracted from $2.029 million is negative $11.5 million.
6. From Table 17.

Table 19 presents the distribution of cash flows of members between the managing member and the passive member.

Table 19
Distribution of estimated cash flows to Legal Entity members ($'000s)

Probability of occurrence	Fees to managing member[2]	Other cash flows[3]		Total PV of estimated cash flows[4]
		Managing member	Passive member	
15%	$5,220	$116	$ 5,690	$11,026
20%	6,488	151	7,378	14,017
30%	7,445	177	8,666	16,288
25%	8,211	230	11,261	19,702

Table 19 Distribution of estimated cash flows to Legal Entity members ($'000s)				
Probability of occurrence	Fees to managing member[2]	Other cash flows[3]		Total PV of estimated cash flows[4]
		Managing member	Passive member	
10%	9,700	352	17,267	27,319
100%				
Expected cash flows[1]	$7,337	$193	$ 9,470	$17,000

Notes:
1. The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example 10.2.10, Table 1 based on a different stream of estimated cash flows.
2. From Table 13.
3. Represents cash flows to members from aircraft and hangar operations (net of fees paid to the managing member) and the changes in fair value of the aircraft. Those cash flows are shared by members in proportion to their carried ownership percentages of 2% and 98%, respectively.
4. From Table 18.

Table 20 presents the calculation of negative variability for each class of variable interest holder based on the information presented in Tables 18 and 19.

Table 20 Negative variability of individual variable interest holders[1] ($'000s)						
Probability of occurrence	Aircraft Lender	Hangar Lender	Managing member	Passive member	Aircraft Guarantor	Total
15%	$ (935)	$ –	$(329)	$ (567)	$(1,725)	$(3,556)
20%	(1,087)	–	(178)	(419)	–	(1,684)
30%	–	–	–	(241)	–	(241)
25%	–	–	–	–	–	–
10%	–	–	–	–	–	–
100%	$(2,022)	$ –	$(507)	$(1,227)	$(1,725)	$(5,481)
Proportionate variability	36.9%	–%	9.2%	22.4%	31.5%	100.0%

Note:
1. The methodology for computing expected losses using probability-weighted estimated cash flows is illustrated in Example 10.2.30, Table 2 based on a different stream of estimated cash flows.

Proportionate variability can also be derived from calculating the positive variability of individual variable interest holders. Negative variability will always be equal (and opposite) to positive variability. Table 21 presents the calculation of positive variability for each individual variable interest holder.

Table 21
Positive variability of individual variable interest holders[1]
($'000s)

Probability of occurrence	Aircraft Lender	Hangar Lender	Managing member	Passive member	Aircraft Guarantor	Total
15%	$ –	$ –	$ –	$ –	$ –	$ –
20%	–	–	–	–	406	406
30%	526	–	27	–	609	1,162
25%	1,068	–	228	448	507	2,251
10%	428	–	252	779	203	1,662
100%	$2,022	$ –	$ 507	$1,227	$1,725	$5,481
Proportionate variability	36.9%	–%	9.2%	22.4%	31.5%	100.0%

Note:

1. The methodology for computing expected losses using probability-weighted estimated cash flows is illustrated in Example 10.2.30, Table 2 based on a different stream of estimated cash flows.

Table 22 presents the allocation of entity-level negative and positive variability (from Table 17) to each of the variable interest holders based on their proportionate variability as calculated in Tables 20 and 21.

Table 22
Allocated expected losses and expected residual returns of individual variable interest holders
($'000s)

	Aircraft Lender	Hangar Lender	Managing member	Passive member	Aircraft Guarantor	Total[2]
Proportionate variability[1]	36.9%	–%	9.2%	22.4%	31.5%	100.0%
Allocated expected losses	$(1,784)	$ –	$(445)	$(1,083)	$(1,522)	$(4,834)
Allocated expected residual returns	$ 1,784	$ –	$ 445	$ 1,083	$ 1,522	$ 4,834

Notes:

1. From Tables 20 and 21.
2. From Table 17.

Question 10.3.20

Is a subordinated variable interest holder's nonperformance risk included in the calculation of expected losses and expected residual returns?

Interpretive response: No. A legal entity's expected losses and expected residual returns are determined based on its design. Therefore, in general we do not believe they are affected by whether variable interest holders will perform as agreed in absorbing those risks and rewards unless the variable interests are non-substantive. As a result, in general we do not believe a legal entity's expected losses and expected residual returns should reflect nonperformance risk of its variable interest holders.

However, we believe the allocation of the legal entity's expected losses and expected residual returns to other variable interest holders should reflect the nonperformance risk of a variable interest holder that may be required to provide future resources to the entity or its other variable interest holders. Specifically, the following amount should be allocated to other variable interest holders:

Probability-weighted likelihood of nonperformance by a variable interest holder	**×**	**Amount of legal entity's variability allocable to that variable interest holder**

Further, when a variable interest holder's interest requires the holder to potentially provide future resources to the entity or to another variable interest holder, we do not believe it is appropriate for the variable interest holder to reduce its share of the entity's expected losses and expected residual returns to reflect the risk of its own nonperformance.

As a result, the allocation of the legal entity's variability to its variable interest holders in such circumstances will generally exceed the entity's total variability. That excess is not eliminated as illustrated in Example 10.3.10.

Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. New Questions and Examples added in this edition are identified throughout the Handbook with **, and items that have been significantly updated or revised are identified with #.

5. Who consolidates a VOE?

Question

5.2.40 How does an enterprise account for a commitment (or option) to purchase a controlling financial interest in an equity method investee? #

6. Who consolidates a VIE?

Question

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Acknowledgments

This Handbook has been produced by the Department of Professional Practice of KPMG LLP in the United States.

We would like to acknowledge the efforts of the main contributors to this edition of the Handbook:

Nick Burgmeier

Molly Chilakapati

Joan Rood

Landon Smith

We would also like to acknowledge the current and former members of the Department who contributed significantly to earlier editions of the Handbook: Kimber Bascom, John Barbagallo, Regina Croucher, Matt Drucker, Shoshana Feldman, Megan Hearn, Lisa Hinkson, Thomas Hoffman, Tim Jinks, Mahesh Narayanasami, Michael Republicano, Julie Santoro, Angie Storm, Rich Sumida.

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