BLUEPRINT: A BDO SERIES

CONTROL AND CONSOLIDATION UNDER ASC 810

May 2024

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Overview

This Blueprint summarizes the guidance in the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 810, *Consolidation,* regarding the variable interest entity (VIE) model and the voting model. It also includes interpretive guidance, examples, and insights on ASC 810.

The core principle in ASC 810 is that a reporting entity consolidates a legal entity when it has a controlling financial interest in that entity. The purpose of consolidated financial statements is to present (primarily for the benefit of the parent's owners and creditors) the results of operations and the financial position of a parent and its subsidiaries as if the consolidated group were a single economic entity. Consolidated financial statements are presumed to be more meaningful than separate financial statements and are usually necessary for a fair presentation when an entity in the consolidated group directly or indirectly has a controlling financial interest in a legal entity. The two primary consolidation models are the VIE model and the voting model.

In the VIE model, a reporting entity (the primary beneficiary) has a controlling financial interest in a VIE if it has power and economics.

Power	Power is the ability to direct the activities that most significantly impact the VIE's economic performance (see Section 4.2).
Economics	Economics is the obligation to absorb the VIE's losses or the right to receive benefits from the VIE that **could** potentially be significant to the VIE (see Section 4.3).

A legal entity is a VIE if it has **any** of the following characteristics:

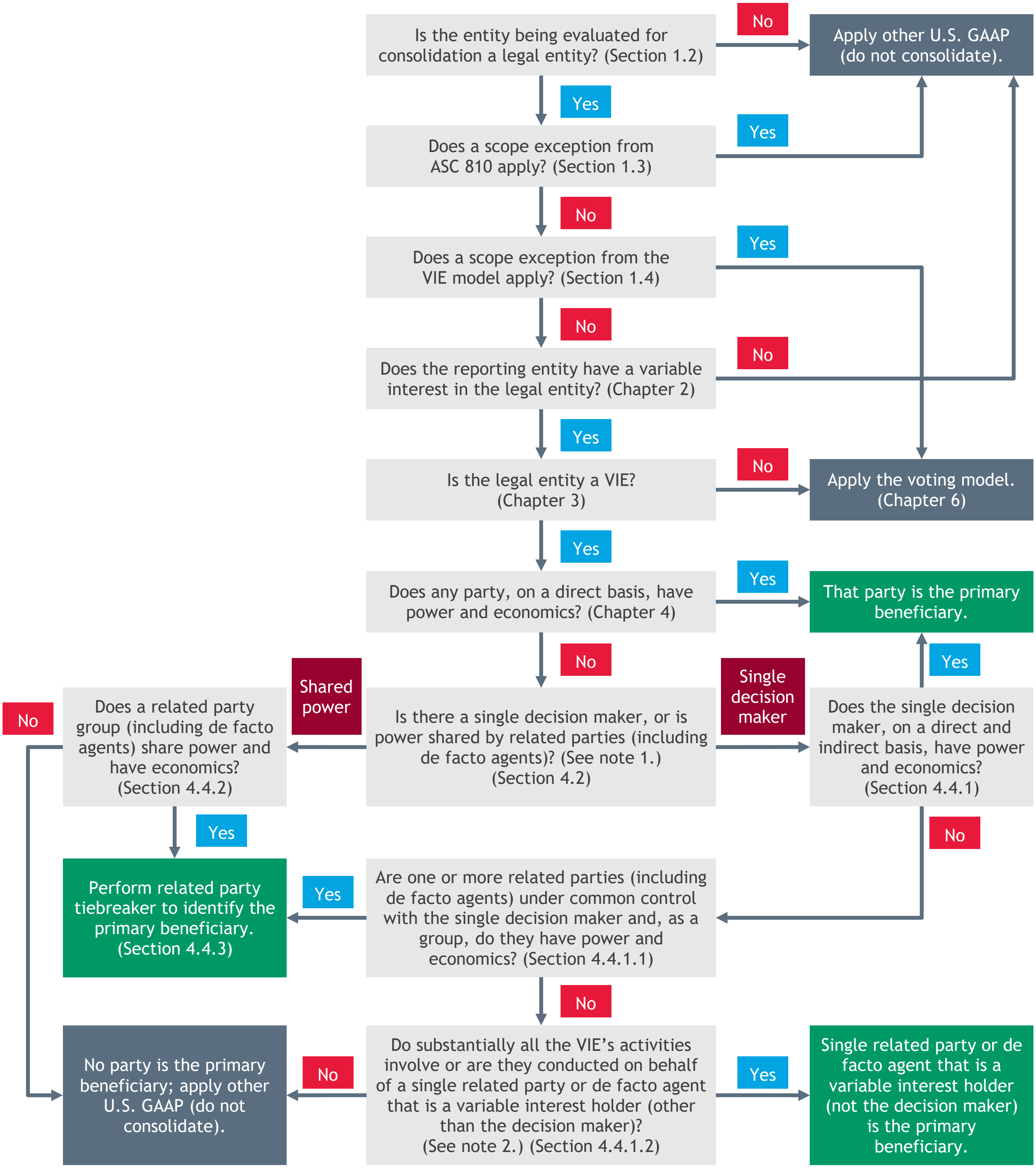
- The equity at risk is insufficient to finance the legal entity's activities without additional subordinated financial support
- The holders of the equity at risk collectively lack the power, through voting rights or similar rights, to direct the activities that significantly impact the legal entity's economic performance
- The holders of the equity at risk collectively lack the obligation to absorb the legal entity's expected losses
- The holders of the equity at risk collectively lack the right to receive the legal entity's expected residual returns
- The voting rights are nonsubstantive (the legal entity fails the antiabuse test)

To determine whether a legal entity is a VIE and to identify its primary beneficiary, a reporting entity analyzes the nature of the risks in the legal entity and obtains an understanding of its purpose and design, including the variability the legal entity was designed to create and pass along to its interest holders. Using this information, the reporting entity identifies which activities most significantly impact the VIE's economic performance and how decisions about those activities are made. Making these determinations requires the application of professional judgment based on the facts and circumstances. The following graphic shows the process.

In contrast, in the voting model, a reporting entity has a controlling financial interest if it directly or indirectly owns more than 50% of a corporation's outstanding voting shares or a limited partnership's kick-out rights through voting interests. However, if other shareholders or limited partners have substantive participating rights, the majority shareholder or limited partner with a majority of kick-out rights does not have a controlling financial interest in the voting interest entity. For guidance on the voting model, see Chapter 6.

ASC 810 IN A NUTSHELL

This flowchart summarizes the guidance in ASC 810-10-05-6.



- **Note 1:** See Section 4.2.3 for guidance when there appear to be multiple decision makers. One of these parties generally is identified as the single decision maker. See Section 4.2.4 for guidance when parties that are not related parties or de facto agents share power.
- **Note 2:** This step applies only if the reporting entity and its related party group (including de facto agents) have power and economics (but no party individually has power and economics) and are not under common control.

SUBSTANTIVE TERMS AND CONDITIONS

FASB REFERENCES

ASC 810-10-15-13A through 15-13B

In the VIE model, a reporting entity considers only substantive terms and arrangements, whether contractual or noncontractual. The reporting entity disregards terms or arrangements that do not substantively affect any of the following:

- A legal entity's status as a VIE (for example, see Section 3.3.4)
- A reporting entity's power over a VIE (for example, see Section 4.2.1)
- A reporting entity's obligation to absorb the legal entity's losses or the right to receive benefits from the legal entity (economics)

Distinguishing between substantive and nonsubstantive terms and arrangements requires the application of professional judgment based on the facts and circumstances.

BDO INSIGHTS — DETERMINING WHETHER TERMS AND AGREEMENTS ARE SUBSTANTIVE

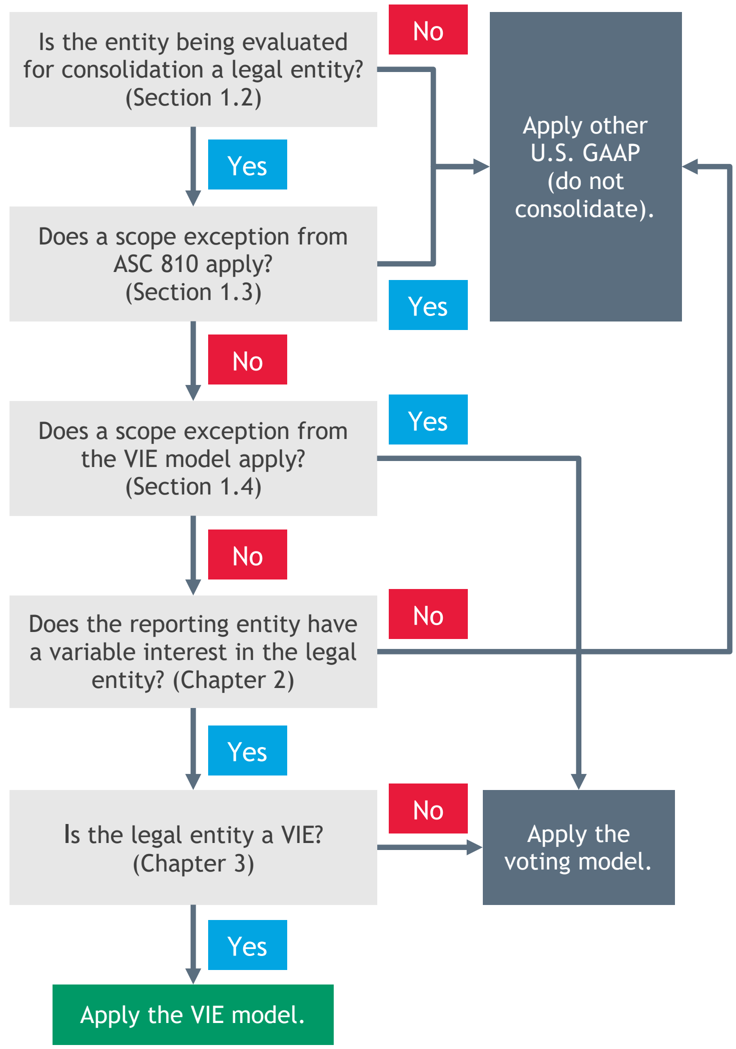
Evaluating the substance of an arrangement can be difficult. It is important to consider:

- The economic and business purpose and design of terms and arrangements (see Section 2.2.2.2)
- The ways in which terms and arrangements vary from what is typical in the industry or from other similar arrangements involving the reporting entity
- The parties' economic motivations and relationships with each other
- The legal enforceability of terms and provisions

We believe written terms and arrangements generally are substantive. However, identifying unusual or inconsistent aspects of terms and arrangements is important when reaching a conclusion.

SCOPE

The consolidation guidance applies to all legal entities with some exceptions. As shown in the flowchart, a reporting entity first determines whether the reporting entity and legal entity are in the scope of the consolidation guidance in ASC 810. The reporting entity then determines whether the reporting entity and legal entity are in the scope of the VIE model; if so, it applies that model. If the legal entity is in the scope of the consolidation guidance but outside the scope of the VIE model, it is a voting interest entity. The reporting entity uses only the guidance in the general subsections of ASC 810 (for example, the voting model; see Chapter 6) to determine whether it controls the voting interest entity.



The term "legal entity" refers to any legal structure used to conduct activities or hold assets (see Section 1.2) such as a corporation, partnership, limited liability company (LLC), or trust. This Blueprint uses the term "legal entity" to refer to the entity being evaluated for potential consolidation, and the term "reporting entity" to refer to the entity evaluating the legal entity for potential consolidation.

Some entities are outside the scope of ASC 810 and are not consolidated:

- Employee benefit plans (see Section 1.3.1)
- Investments accounted for at fair value in accordance with ASC 946, *Financial Services — Investment Companies* (see Section 1.3.2)
- Most governmental organizations and governmental financing entities (see Section 1.3.3)
- Money market funds required to comply with Rule 2a-7 of the Investment Company Act of 1940 (the 1940 Act) or similar requirements (see Section 1.3.4)

The following legal entities are in the scope of the consolidation guidance (for example, the voting model) but outside the scope of the VIE model:

- Most not-for-profit (NFP) entities (see Section 1.4.1)
- Separate accounts of life insurance reporting entities described in ASC 944, *Financial Services — Insurance* (see Section 1.4.2)
- Some legal entities created before December 31, 2003 (see Section 1.4.3)
- Businesses (as defined in ASC 805, *Business Combinations*) that meet specific conditions (see Section 1.4.4)
- A legal entity under common control with a private company that elects the private company accounting alternative (see Section 1.4.5)

IDENTIFYING A VARIABLE INTEREST

If a reporting entity cannot (or does not elect to) apply a consolidation or VIE scope exception, the reporting entity next determines whether it has a variable interest in the legal entity (see Chapter 2). Variable interests are defined in ASC 810-10-20 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.*"

A legal entity's assets and activities generally **create** variability and thus are not variable interests, while its liabilities and equity generally **absorb** variability and therefore are variable interests. Other contracts or arrangements, such as derivatives, are sometimes assets and sometimes liabilities. The role of a contract or arrangement in the legal entity's design dictates whether an interest creates or absorbs variability regardless of its legal form or accounting classification. A reporting entity generally can qualitatively identify which factors contribute to the expected variability, based on the legal entity's purpose and design. Sometimes, determining whether an interest or arrangement is a variable interest is straightforward. Other times, the determination requires the application of professional judgment based on the facts and circumstances. A reporting entity uses two steps, described in more detail in Section 2.2, to determine whether an interest or arrangement is a variable interest.

Step 1: Analyze the nature of the risks in the legal entity

Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders

Variable interests can be explicit or implicit. This table lists examples of potential explicit variable interests (it is not intended to be exhaustive).

POTENTIAL VARIABLE INTERESTS	GUIDANCE
Equity instruments	Section 2.3.1
Debt and beneficial interests	Section 2.3.2
Guarantees	Section 2.3.3
Derivatives and potential derivatives (including embedded derivatives, call options, put options, and forward contracts)	Section 2.3.4
Purchase or supply arrangements	Section 2.3.5
Leases	Section 2.3.6
Licenses and royalty arrangements	Section 2.3.7
Fees paid to a decision maker or service provider	Section 2.3.8

An interest in specified assets of a legal entity (for example, a residual value guarantee on an asset) is a variable interest in that entity as a whole if certain conditions are met (see Section 2.4). A reporting entity with an interest in specified assets of a VIE treats part of the VIE as a silo if the specified assets are essentially the only source of payment for specified liabilities or specified other interests (see Section 2.5).

A reporting entity must also determine whether it has an implicit variable interest in a legal entity, which is described in ASC 810-10-25-51 as "*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*" (see Section 2.6).

IDENTIFYING A VIE

Once a reporting entity determines that it has a variable interest in a legal entity in the scope of the VIE model, it next determines whether the legal entity is a VIE (see Chapter 3). If a legal entity is not a VIE, the reporting entity evaluates whether it controls the legal entity in accordance with the voting model or other general subsections of ASC 810 (see Chapter 6).

Identifying which model to apply is important because the models may result in different consolidation conclusions. The usual condition in the voting model for a controlling financial interest in a legal entity is ownership of a majority voting interest. However, that condition is not effective in identifying a controlling financial interest for some legal entities. The VIE model is designed to identify legal entities structured so the equity holders do not have the normal risks, rewards, and decision-making rights that generally belong to equity holders. Therefore, a reporting entity must apply the VIE model if the legal entity has **any** characteristics of a VIE listed in the following table.

CHARACTERISTIC		GUIDANCE
Equity at risk	The equity at risk is insufficient to finance the legal entity's activities without additional subordinated financial support.	Section 3.2
Power	The holders of the equity at risk **collectively** lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the legal entity's economic performance.	Section 3.3
Expected losses	The holders of the equity at risk **collectively** lack the obligation to absorb the legal entity's expected losses.	Section 3.4
Expected residual returns	The holders of the equity at risk **collectively** lack the right to receive the legal entity's expected residual returns.	Section 3.5
Voting rights are nonsubstantive	The voting rights are nonsubstantive because **both** criteria are met: ▶ The voting rights of some investors are not proportional to their economic exposure to the legal entity. ▶ Substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights, including that investor's related parties and specific de facto agents.	Section 3.6

ASC 810 does not require a reporting entity to evaluate the VIE characteristics in sequence. If a legal entity appears to have one characteristic of a VIE, it may be more efficient to evaluate that characteristic first because the legal entity is a VIE if it has any characteristic of a VIE. On the other hand, for a legal entity to be a voting interest entity, it **cannot have any** VIE characteristics (the reporting entity must evaluate all five VIE characteristics).

When evaluating whether the holders of the equity at risk collectively lack power, specific aspects of the evaluation vary depending on whether the legal entity is a corporation (or similar entity) or a limited partnership (or similar entity). Determining whether a legal entity is more like a corporation or more like a limited partnership requires the application of professional judgment based on the facts and circumstances (see Section 3.3.1).

A reporting entity determines whether a legal entity is a VIE when it first becomes involved with the legal entity, based on the legal entity's purpose and design. After the initial determination, the reporting entity reassesses whether the legal entity is a VIE only upon reconsideration events (see Section 3.7). A legal entity does not become a VIE solely because it incurs losses that reduce its equity at risk. That said, losses that reduce the equity at risk may increase the likelihood of a reconsideration event (for example, restructuring debt). Therefore, a reporting entity should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances that could affect its analysis.

IDENTIFYING THE PRIMARY BENEFICIARY

If a legal entity is a VIE, the next step is to determine whether the reporting entity controls and consolidates the VIE — that is, to identify the primary beneficiary (see Chapter 4). A reporting entity is the primary beneficiary and consolidates a VIE when it has a controlling financial interest in the VIE. A reporting entity is the primary beneficiary of a VIE if it has power and economics.

Power

Power is the ability to direct the activities that most significantly impact the VIE's economic performance (see Section 4.2).

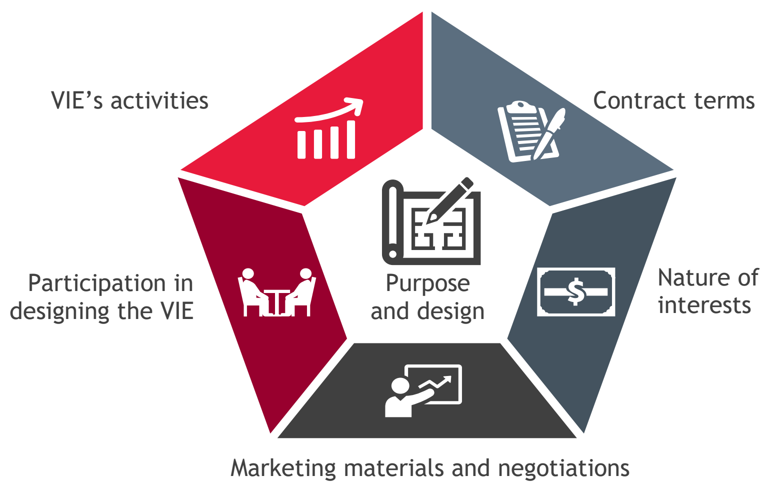
To identify the party with power, the reporting entity analyzes the nature of the risks in the VIE and determine the VIE's purpose and the variability it is designed to create and pass along to its interest holders. The reporting entity must then identify the activities that most significantly impact the VIE's economic performance and determine how those activities are directed. A reporting entity has power if it has the right to direct the activities that most significantly impact the VIE's economic performance, even if that right is triggered only if specific circumstances arise or specific events happen. A reporting entity does not have to exercise its rights to have power.

Economics

Economics is the obligation to absorb the VIE's losses or the right to receive benefits from the VIE that **could** potentially be significant to the VIE (see Section 4.3).

Determining whether a party has economics is both qualitative and quantitative. When assessing whether a party has economics, factors to consider include:

- The VIE's purpose and design, including the risks it was designed to create and pass along to its interest holders (consistent with the identification of variable interests)
- The variable interest's terms and characteristics and the nature of the variability absorbed (consistent with the identification of variable interests)
- The reasons for holding the financial interest
- The magnitude of the **variability** absorbed



Identifying the primary beneficiary is mostly a qualitative assessment. Often, more than one party has economics, but only one party, if any, has power.

If no party individually is the primary beneficiary (no party individually has power and economics), the reporting entity must determine whether a related party group (including de facto agents) collectively has the characteristics of a primary beneficiary (power and economics). That may require one party in the group to be identified as the primary beneficiary and consolidate the VIE (see Section 4.4).

The identification of the primary beneficiary is an ongoing assessment (see Section 4.5). Therefore, a reporting entity should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances that could affect its analysis.

RELATED PARTIES AND DE FACTO AGENTS

In ASC 810, the term “related parties” includes parties identified in ASC 850, *Related Party Disclosures,* and generally includes de facto agents.

Related parties include (see Section 5.2):

- Affiliates of the reporting entity
- Entities that would be accounted for using the equity method, absent electing the fair value option
- Trusts for the benefit of employees, such as pension and profit-sharing trusts managed by or under the trusteeship of management
- Principal owners of the reporting entity and their immediate families
- Management of the reporting entity and their immediate families
- Other parties with which the reporting entity may deal if one party controls or can significantly influence the management or operating policies of the other such that one of the transacting parties might be prevented from fully pursuing its own separate interests
- 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 such that one or more of the transacting parties might be prevented from fully pursuing its own separate interests

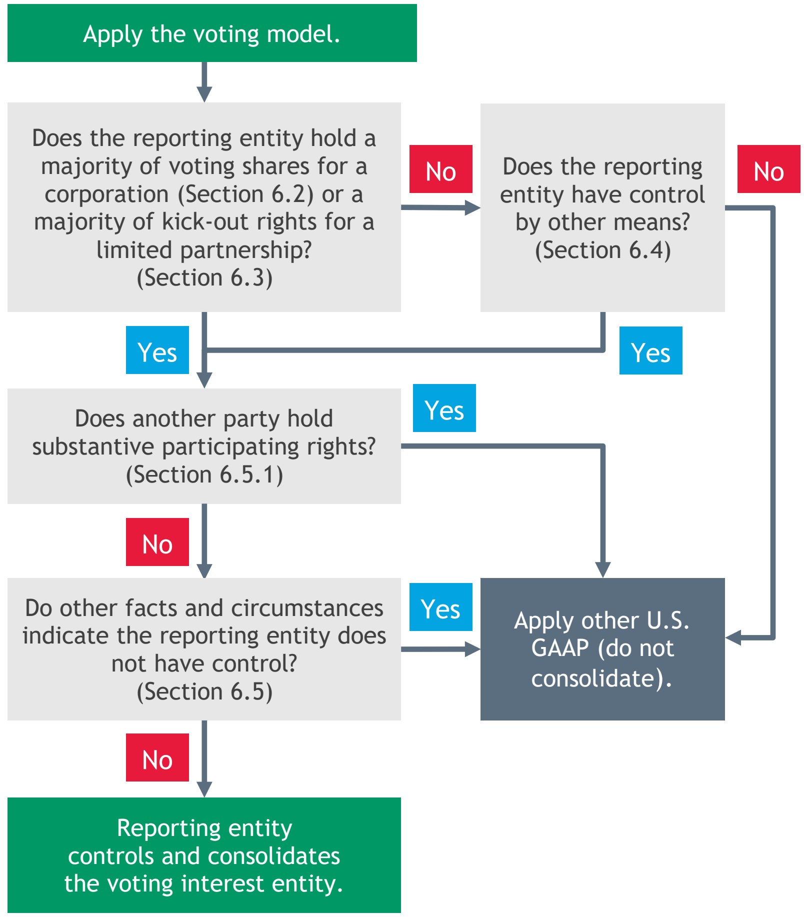
De facto agents include parties that (see Section 5.3):

- Cannot finance their activities without subordinated financial support from the reporting entity; for example, another VIE of which the reporting entity is the primary beneficiary
- Received their interests as a contribution or a loan from the reporting entity
- Are officers, employees, or members of the governing board of the reporting entity
- Cannot sell, transfer, or encumber their interests in the VIE without the approval of the reporting entity
- Have a close business relationship, such as the relationship between a professional service provider and a significant client

This table shows where related parties and de facto agents are considered in the VIE model:

RELATED PARTY (AND DE FACTO AGENT) CONSIDERATIONS IN THE VIE MODEL	
Scope Exceptions	▶ Not-for-profit entities (see Section 1.4.1) ▶ Business scope exception (see Section 1.4.4)
Variable Interests	▶ Fees paid to a decision maker or service provider (see Section 2.3.8.2) ▶ Implicit variable interests (see Section 2.6)
Identifying a VIE	▶ Corporations: Evaluating kick-out rights and participating rights (see Section 3.3.2) ▶ Limited partnerships: Evaluating kick-out rights and participating rights (see Section 3.3.3) ▶ Assessing whether substantially all the legal entity’s activities involve or are conducted on behalf of a related party group, including specific de facto agents (see Section 3.6.2)
Identifying the Primary Beneficiary	▶ Identifying whether a single party (including its related parties and de facto agents) holds substantive kick-out rights or participating rights (see Section 4.2.2) ▶ Identifying the primary beneficiary in a related party group (including de facto agents) (see Section 4.4)
Initial Measurement	▶ Initial measurement of a VIE if the VIE and its primary beneficiary were under common control before the primary beneficiary’s initial consolidation of the VIE (see Section 7.2.1)

VOTING MODEL



If a legal entity is in the scope of the consolidation guidance but outside the scope of the VIE model, it is a voting interest entity. The reporting entity uses only the guidance in the general subsections of ASC 810 (for example, the voting model or the "Consolidation of Entities Controlled by Contract" subsection) to determine whether it controls the voting interest entity (see Chapter 6).

In the voting model (as shown in the flowchart), a reporting entity generally has a controlling financial interest if it directly or indirectly owns more than 50% of a corporation's outstanding voting shares (see Section 6.2) or more than 50% of a limited partnership's kick-out rights through voting interests (see Section 6.3).

However, in the voting model, if other shareholders or limited partners have substantive participating rights, the majority shareholder (or the limited partner with a majority of kick-out rights through voting interests) does not have a controlling financial interest (see Section 6.5.1) in the legal entity.

Control of a legal entity may also exist by other means; for example:

- Control of a not-for-profit entity (see Section 6.4.1).
- Control by contract (see Section 6.4.2).
- Control over specific research and development (R&D) arrangements (see Section 6.4.3).
- Control of a rabbi trust that is not a VIE (see Section 6.4.4).
- Control with less than a majority ownership (see Section 6.4.5).

Other facts and circumstances can also overcome the presumption that the majority shareholder (or the limited partner with a majority of kick-out rights through voting interests) controls the voting interest entity, including:

- The voting interest entity is in bankruptcy (see Section 6.5.2).
- The voting interest entity operates under foreign exchange restrictions, controls, or other government imposed uncertainties so severe they cast significant doubt on the majority owner's ability to control the voting interest entity (see Section 6.5.3).
- Another party holds an option (or other instrument) to acquire a majority of the voting interests (or a majority of kick-out rights through voting interests) that is deep-in-the-money and currently exercisable (see Section 6.5.4).
- The reporting entity is a broker-dealer in the scope of ASC 940, *Financial Services — Brokers and Dealers*, and control is likely temporary (other reporting entities cannot apply this scope exception by analogy).

When evaluating whether a reporting entity controls a voting interest entity, specific aspects of the evaluation vary depending on whether the legal entity is a corporation (or similar entity) or a limited partnership (or similar entity). Determining whether a legal entity is more like a corporation or more like a limited partnership requires the application of professional judgment based on the facts and circumstances (see Section 3.3.1).

MEASUREMENT

A reporting entity (the parent) consolidates a legal entity (the subsidiary) as of the date it obtains control of the legal entity (not at the beginning or end of a reporting period) and does not recast prior periods.

It is important to determine whether a legal entity is a VIE because that can affect its initial measurement. This table shows some common fact patterns and the applicable initial measurement guidance.

FACT PATTERN	GUIDANCE
The VIE and its primary beneficiary were under common control before the primary beneficiary's initial consolidation of the VIE.	Apply the common control guidance in ASC 810 (that is, carryover basis) and do not recognize a gain or loss (see Section 7.2.1).
The voting interest entity and its parent were under common control before the initial consolidation of the voting interest entity.	Apply the common control guidance in ASC 805-50, *Business Combinations — Related Issues* (that is, carryover basis).
The VIE or voting interest entity is a business.	Apply the acquisition method in ASC 805, including recognizing goodwill (see Section 7.2.2).
The VIE is not a business.	Apply the acquisition method in ASC 805 but recognize a gain or loss instead of goodwill (see Section 7.2.2).
The voting interest entity is not a business.	Apply the asset acquisition guidance in ASC 805-50.
The VIE is a collateralized financing entity (CFE).	Decide whether to elect the fair value measurement alternative (see Section 7.2.3).
The VIE or voting interest entity is contributed to (or formed by) a joint venture at the joint venture's formation date (after adopting ASU 2023-05).	Apply the guidance in ASC 805-60, *Business Combinations — Joint Venture Formations* (see Section 7.2.4).

After initial measurement, the consolidation principles in ASC 810 apply to both VIEs and voting interest entities. The subsequent measurement of the subsidiary's assets, liabilities, and noncontrolling interest (NCI) generally are the same regardless of whether the subsidiary is a VIE or a voting interest entity, including retaining specialized or industry-specific accounting. However, ASC 810 includes specific guidance for eliminating intra-entity transactions between a VIE and its primary beneficiary (see Section 7.3.1).

PRESENTATION AND DISCLOSURE

ASC 810 contains general presentation and disclosure requirements that apply to both VIEs and voting interest entities. Chapter 8 focuses on incremental presentation and disclosure requirements for VIEs.

The primary beneficiary is required to separately present specific assets and liabilities of the VIE on its balance sheet (see Section 8.2) but does not have to separately present a consolidated VIE's income, expenses, or cash flows (although it is not prevented from doing so).

As discussed in Section 8.3, ASC 810 also requires specific disclosures for:

- The primary beneficiary of a VIE
- All other variable interest holders in a VIE
- A reporting entity that uses a scope exception from the VIE model

ABOUT THIS BLUEPRINT

This Blueprint summarizes ASC 810 after adopting the following Accounting Standards Updates (ASUs), which are collectively referred to as ASC 810 in this publication:

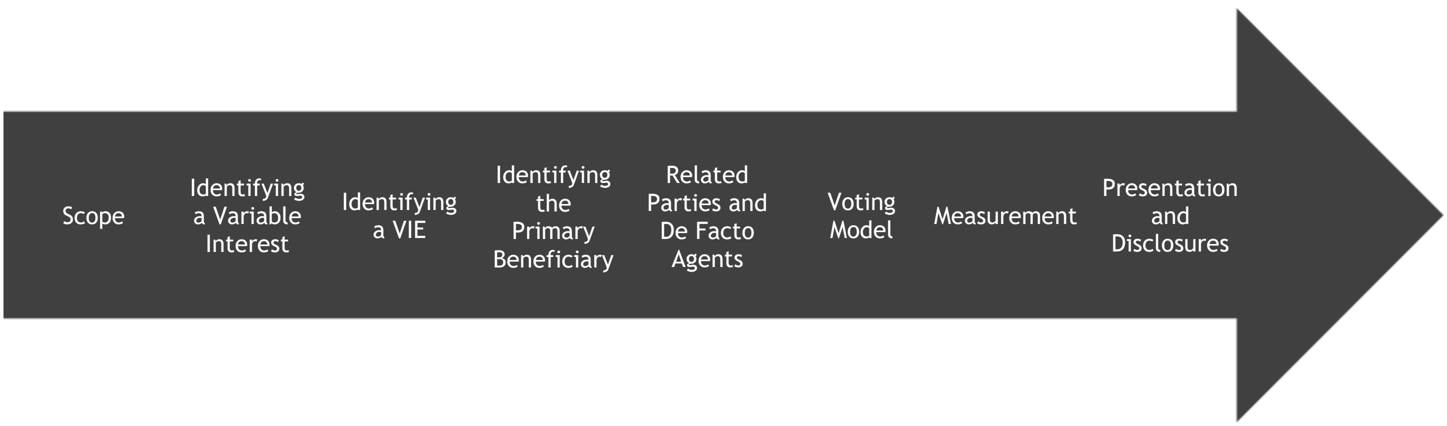
- ASU 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis
- ASU 2016-17, Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control
- ASU 2018-07, Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities

This Blueprint also includes consequential amendments to ASC 810 from the following ASUs:

- ASU 2023-02, *Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method* (see BDO's **Bulletin** for guidance on effective dates)
- ASU 2023-05, *Business Combinations — Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement* (see BDO's **Bulletin** for guidance on effective dates)

This Blueprint summarizes key aspects of ASC 810 and includes practical examples and interpretive guidance to help companies and practitioners apply ASC 810, organized into chapters in the order a reporting entity applies ASC 810. The facts and circumstances of actual contracts and arrangements vary, so a reporting entity's facts and accounting conclusion may differ from the illustrations in this Blueprint.

The arrow shows the organization of this Blueprint.



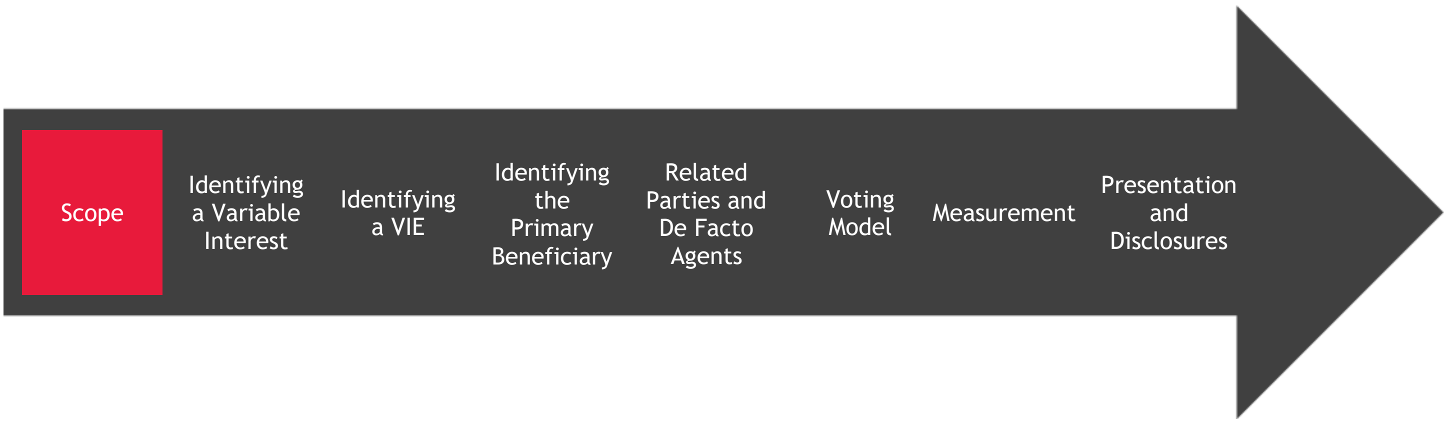
This Blueprint focuses on U.S. GAAP. More information on control and consolidation under International Financial Reporting Standards (IFRS) is available **here**.

Future Standard Setting

FASB PROJECT — CONSOLIDATION FOR BUSINESS ENTITIES

In April 2022, the FASB added a research project to its agenda to explore whether it can develop a single consolidation model for business entities. This project does not include reconsideration of the consolidation guidance in Topic 958, *Not-for-Profit Entities*. No further decisions have been made. See the **FASB website** for information.

Chapter 1 — Scope



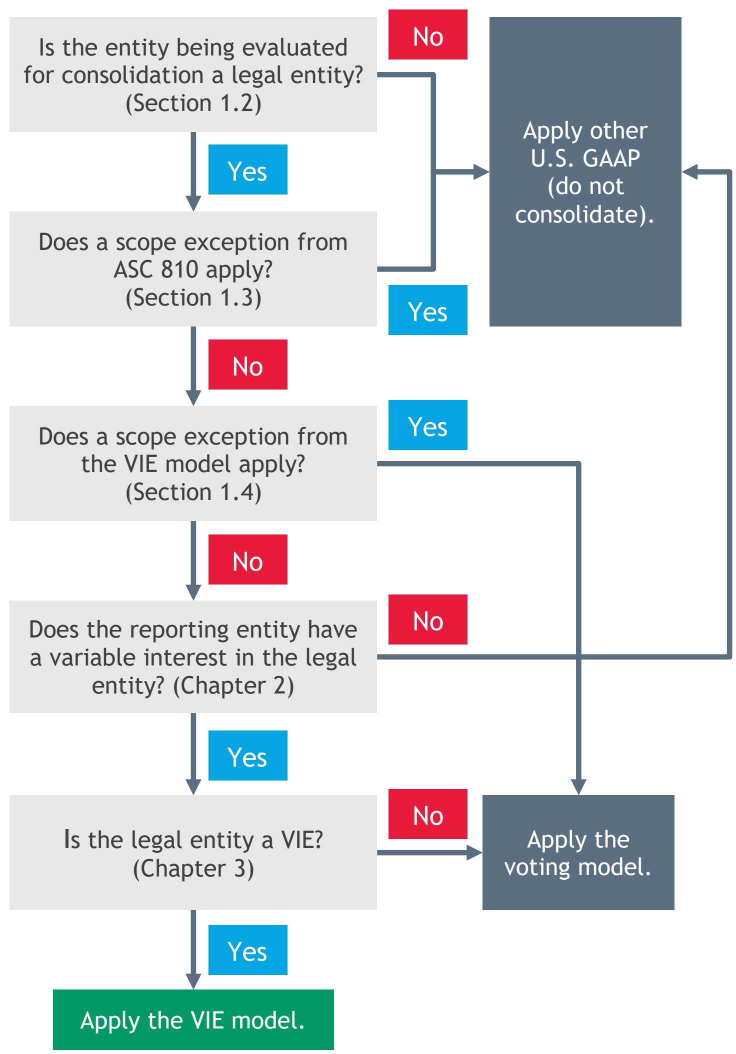
1.1 OVERVIEW

The consolidation guidance applies to all legal entities with some exceptions. As shown in the flowchart, a reporting entity first determines whether the reporting entity and legal entity are in the scope of the consolidation guidance in ASC 810. The reporting entity then determines whether the reporting entity and legal entity are in the scope of the VIE model; if so, it applies that model. If the legal entity is in the scope of the consolidation guidance but outside the scope of the VIE model, the reporting entity uses only the guidance in the general subsections of ASC 810 (for example, the voting model; see Chapter 6).

The term "legal entity" refers to any legal structure used to conduct activities or hold assets (see Section 1.2), such as a corporation, partnership, LLC, or trust. This Blueprint uses the term "legal entity" to refer to the entity being evaluated for potential consolidation, and the term "reporting entity" to refer to the entity evaluating the legal entity for potential consolidation.

Some entities are outside the scope of ASC 810 and are not consolidated:

- Employee benefit plans (see Section 1.3.1)
- Investments accounted for at fair value in accordance with ASC 946 (see Section 1.3.2)
- Most governmental organizations and governmental financing entities (see Section 1.3.3)
- Money market funds required to comply with Rule 2a-7 of the 1940 Act or similar requirements (see Section 1.3.4)



The following entities are in the scope of ASC 810 (e.g., the voting model) but outside the scope of the VIE model:

- Most NFP entities (see Section 1.4.1)
- Separate accounts of life insurance reporting entities described in ASC 944, *Financial Services — Insurance* (see Section 1.4.2)
- Some legal entities created before December 31, 2003 (see Section 1.4.3)
- Businesses (as defined in ASC 805) that meet specific conditions (see Section 1.4.4)
- A legal entity under common control with a private company that elects the private company accounting alternative (see Section 1.4.5)

1.2 LEGAL ENTITY

FASB REFERENCES

ASC 810-10-15-4, ASC 810-10-15-15, and ASC 810-10-20: Legal Entity

All legal entities are subject to the VIE model unless a scope exception from ASC 810 or the VIE model applies. The term "legal entity" is defined as "*any legal structure used to conduct activities or to hold assets*." A portion of a legal entity is not treated as a separate legal entity unless the entire legal entity is a VIE and the portion meets the definition of a silo (see Section 2.5). Whether a structure is a legal entity is based on the facts and circumstances.

This table includes examples of structures that generally meet (or do not meet) the definition of a legal entity.

LEGAL ENTITIES	GENERALLY NOT LEGAL ENTITIES
▶ Corporations, partnerships, limited partnerships, and LLCs ▶ Franchises ▶ Trusts, including grantor trusts • See Section 1.3.1 for employee benefit plans and rabbi trusts • See Section 2.3.1.1 for trust-preferred securities arrangement ▶ Securitization vehicles, including commercial paper conduits and collateralized debt obligations	▶ Asset pools ▶ Branches ▶ Fiduciary accounts and assets held in trust not in a separate legal entity ▶ Divisions ▶ Departments ▶ Undivided interests

MAY OR MAY NOT BE LEGAL ENTITIES (DEPENDING ON THE FACTS AND CIRCUMSTANCES)
▶ A collaborative arrangement, which is a contractual arrangement involving a joint operating activity and active participants that are exposed to significant risks and rewards that depend on the arrangement's commercial success; it may be conducted in one or more legal entities or may instead be conducted through the parties to the collaborative arrangement.
▶ A joint venture, as defined in ASC 323, *Investments — Equity Method and Joint Ventures*, is a legal entity with specific characteristics (see Section 1.4.4.1). However, the term "joint venture" is used loosely in practice and may refer to a structure conducted in one or more legal entities or through an arrangement or contract between the parties.
▶ A fund may be set up as a limited partnership or LLC, which are legal entities, or as one fund in a series of funds **within** a single corporation or trust (a series fund). A series fund may or may not meet the definition of a legal entity depending on the facts and circumstances (see Section 1.2.2).

BDO INSIGHTS — DETERMINING WHETHER A STRUCTURE IS A LEGAL ENTITY

When determining whether a structure is a legal entity, particularly when evaluating a structure outside the U.S., we believe a reporting entity should evaluate whether the structure can (in its own name):

- Enter contracts and agreements
- Open bank or investment accounts
- Invoice customers or buy supplies from vendors
- Lend money or issue debt
- Start or become party to legal proceedings
- File a tax return or other report with a regulator
- Issue financial statements

None of these factors is determinative. For example, a structure need not incorporate or register with a government or regulator to be a legal entity. Reaching a conclusion about whether a structure is a legal entity requires the application of professional judgment based on the facts and circumstances.

1.2.1 Common Legal Entities

Some common legal entities by industry are listed below.

Asset Management	▶ Registered funds,[1] hedge funds, private equity funds, venture capital funds, real estate funds, commodity funds, and similar legal entities ▶ Standalone funds, fund of funds, master funds, feeder funds, aggregator funds, onshore funds, offshore funds, side-by-side funds, and co-investment funds set up for employees ▶ Entities (such as limited partnerships or LLCs) designed to function as general partners, managing members, advisors, or managers to other funds ▶ Intermediate holding companies, special purpose vehicles, blocker entities for tax purposes ▶ Portfolio entities
Consumer Services, Restaurants, and Hospitality	▶ Auto dealership partnerships and franchises ▶ Gaming corporations ▶ Hotel franchisees and the partnerships or LLCs that own the underlying real estate ▶ Restaurant franchisees and the partnerships or LLCs that own the underlying real estate ▶ Retailers and the partnerships or LLCs that own the underlying real estate
Financial Services	▶ Commercial paper conduits ▶ Collateralized debt obligation entities ▶ Single-purpose insurance and reinsurance entities ▶ Entities created to issue commercial or residential mortgage-backed obligations ▶ Securitization vehicles for consumer or other loans

[1] A registered fund is a fund that is registered under the Investment Company Act of 1940; for example, open-end funds (mutual funds) and closed-end funds.

Government Contracting	▶ Entities created to bid on a single project, contract, or particular geographic area
Healthcare and Life Sciences	▶ R&D entities ▶ Entities created as part of a collaborative arrangement or joint venture ▶ Partnerships or LLCs that own the real estate for hospitals
Manufacturing	▶ Entities created to manufacture goods for one or more customers ▶ Entities created to manufacture in a particular geographic area
Natural Resources	▶ Entities created for renewable energy projects (e.g., wind farms, solar farms) ▶ Entities created to enter power purchasing arrangements ▶ Entities created for oil, gas, or mineral exploration in a particular location
Nonprofit and Education	▶ NFP entities (see Section 1.4.1) ▶ Charitable foundations set up by for-profit entities (see Section 1.4.1) ▶ For-profit education franchises
Professional Services	▶ Entities created to bid on a single project, contract, or particular geographic area
Public Sector	▶ Entities created to receive aid from domestic, foreign, local, regional, and national or federal governments and entities related to those governments ▶ Entities created for public-private partnerships (for example, airport terminals, roads)
Real Estate and Construction	▶ Partnerships, LLCs, or similar entities that own real estate ▶ Entities created for build-to-suit or sale-leaseback arrangements ▶ Single-asset lessors (see Section 2.3.6 for guidance on determining whether a lease is a variable interest) ▶ Entities created to hold land subject to forward contracts (see Section 2.3.4.5 for guidance on determining whether forward contracts are variable interests) ▶ Real estate investment trusts ▶ Entities created to bid on a single project, contract, or particular geographic area
Technology	▶ R&D entities ▶ Entities created as part of a collaborative arrangement or a joint venture ▶ Entities created to manufacture or distribute in a particular geographic area

1.2.2 Series Funds (Mutual Funds)

FASB REFERENCES

ASC 810-10-55-8A through 55-8H

Series funds (which are common in asset management) are funds set up using a single umbrella corporation or trust that has one board of directors or trustees and one set of by-laws but also has a series of individual mutual funds in which an investor can invest. Each fund is designed to be economically isolated from other funds in the series.

The umbrella corporation or trust and each series fund is set up in accordance with the 1940 Act. As discussed in BC38-BC39 of ASU 2015-02, each series fund that complies with the 1940 Act's requirements is treated as a separate legal entity when applying ASC 810 because it:

- Has its own investment purpose, objectives, strategies, and policies
- Has its own custodial agreement and distributes its returns only to its shareholders
- Has its own shareholders separate from other series funds
- Has a unique tax identification number
- Files a separate tax return with the IRS
- Has separate audited financial statements
- Is virtually always considered a separate investment company for investor protection purposes by the SEC staff

It may be challenging to determine whether a fund or structure that is not registered under the 1940 Act is a legal entity, particularly for a fund or structure outside the U.S. The Asset Management Accounting Policy Committee of the Securities Industry and Financial Markets Association (SIFMA) and the Asset Management Industry Accounting Policy Group discussed international series funds with the SEC staff and confirmed their understandings in a January 2016 letter.

JANUARY 2016 LETTER FROM SIFMA TO SEC STAFF

The SEC Staff would not object to the view that the considerations listed in ASU 2015-02, paragraph BC38, be considered indicators as to whether an individual series fund is a legal entity; rather than a prescribed list of criteria that must all be met.

The SEC Staff believes the determination as to whether an individual series fund is a separate legal entity for consolidation purposes requires the application of reasonable judgment and includes, but is not limited to, consideration of the following:

- *The definition of a legal entity as defined in the Master Glossary,*
- *The considerations in paragraph BC38 in the Basis for Conclusions of ASU 2015-02 [listed in the bullets above],*
- *The purpose, objective and strategy of each of the series funds within the umbrella,*
- *The legal isolation of the assets, liabilities, and equity (i.e., segregation of assets and liabilities) of each of the individual series funds,*
- *Whether the shareholders of an individual series fund have substantive decision-making rights related to the individual series fund; such rights include, but are not limited to, the ability to directly remove and replace the asset management company for the individual series fund or liquidate the individual*

series fund, approve the compensation of the asset management company for the individual series fund, and vote on changes to the fundamental investment strategy of the individual series fund, and

- *Other relevant jurisdictional characteristics.*

The SEC Staff believes that legal isolation of the assets, liabilities and equity of each of the individual series funds and the existence of substantive shareholder decision-making rights at the series fund level can be viewed as relevant and significant considerations in the context of the asset management industry and, as a result, the SEC Staff would expect that in many series fund structures where these two considerations are present, the individual series fund would qualify as a separate legal entity for purposes of the consolidation analysis.

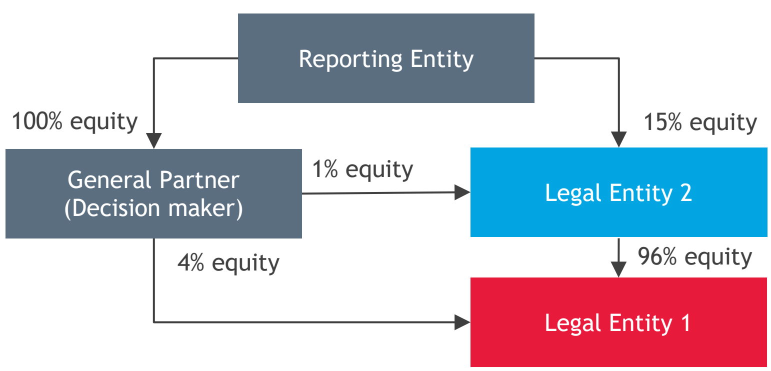
SERIES FUNDS IN FOREIGN COUNTRIES MAY NOT HAVE SIMILAR ATTRIBUTES TO U.S. FUNDS

A reporting entity evaluates the facts and circumstances to determine whether a series fund or similar structure that is not registered under the 1940 Act (such as a fund or structure in a foreign country) is a legal entity as defined in ASC 810. If each series fund is not a separate legal entity, the reporting entity evaluates whether the individual series funds are silos and whether the umbrella legal entity is a VIE (see Section 2.6). If the individual series funds are not silos (or the umbrella legal entity is not a VIE), the reporting entity evaluates whether it controls the umbrella legal entity (and not the individual series funds).

1.2.3 Complex Organizational Structures

When evaluating complex organizational structures, a reporting entity generally begins its analysis at the lowest level of the organizational chart and moves upward (a bottoms-up approach).

In the chart, the reporting entity would first evaluate which entity controls legal entity 1 and then evaluate which entity controls legal entity 2 and the general partner.



However, sometimes a reporting entity needs to analyze control at the top of an organizational structure to complete its analysis of a lower-tier entity. For example, a reporting entity may need this information to determine whether it:

- May apply the private company accounting alternative (see Section 1.4.5)
- Is part of a related party group (including de facto agents) that collectively has the characteristics of a primary beneficiary (power and economics, see Section 4.4)
- Is part of a common control group when determining a VIE's initial measurement (see Section 7.2.1)

1.2.4 Majority-Owned Entities

FASB REFERENCES

ASC 810-10-15-9

A reporting entity with a majority interest in a legal entity does not always control that majority-owned entity. For example, the majority-owned entity may be a VIE and the reporting entity might not be its primary beneficiary. Therefore, a reporting entity must evaluate a majority-owned entity in accordance with ASC 810 (like it would for any other legal entity) and cannot conclude simply based on having a majority ownership interest.

VIE STATUS MATTERS

Determining whether a legal entity is a VIE can affect:

- Initial measurement if the legal entity is not a business: U.S. GAAP has different requirements for the initial consolidation of a VIE that is not a business than for other asset acquisitions (see Section 7.2.2).
- Identifying the acquirer in a business combination: If the legal acquiree is a VIE, its primary beneficiary is always the accounting acquirer. If the legal acquiree is not a VIE, additional analysis may be necessary to determine which of the combining entities is the accounting acquirer (see Section 7.2).
- Disclosures (see Section 8.3).

1.3 SCOPE EXCEPTIONS TO THE CONSOLIDATION GUIDANCE IN ASC 810

FASB REFERENCES

ASC 810-10-15-12

Some legal entities are outside the scope of ASC 810 and are not consolidated using the VIE model or voting model:

- Employee benefit plans (see Section 1.3.1)
- Investments accounted for at fair value in accordance with ASC 946 (see Section 1.3.2)
- Most governmental organizations and governmental financing entities (see Section 1.3.3)
- Money market funds required to comply with Rule 2a-7 of the 1940 Act or similar requirements (see Section 1.3.4)

1.3.1 Employee Benefit Plans

FASB REFERENCES

ASC 810-10-15-12(a), ASC 960-325-35-1, ASC 962-325-35-1, and ASC 965-325-35-1

An employer does not consolidate an employee benefit plan in the scope of ASC 712, *Compensation — Nonretirement Postemployment Benefits*, or ASC 715, *Compensation — Retirement Benefits*. Such plans are outside the scope of the consolidation guidance for the employer sponsor.

However, a reporting entity that makes decisions or provides services to a plan, including an investment manager, trustee, or administrator, is in the scope of the consolidation guidance and must evaluate whether it has a variable interest in the plan; for example, fees that are variable interests (see Section 2.3.8).

While not specifically addressed in ASC 810, the financial statements of defined benefit plans, defined contribution plans, and other employee health and welfare benefit plans also generally do not apply ASC 810 because these plans account for their investments at fair value.

BDO INSIGHTS — OTHER EMPLOYEE BENEFIT PLANS

ASC 810 does not state whether an employer sponsor can apply the consolidation scope exception to employee benefit plans other than those in the scope of ASC 712 and ASC 715. However, in practice, employer sponsors exclude the following employee benefit plans from the scope of ASC 810:

- Nonretirement postemployment benefit plans in the scope of ASC 712
- Retirement benefit plans in the scope of ASC 715
- Employee stock ownership plans in the scope of ASC 718, Compensation — Stock Compensation.
- Employee benefit plans in the scope of:
  - ASC 960, Plan Accounting — Defined Benefit Pension Plans
  - ASC 962, Plan Accounting — Defined Contribution Pension Plans
  - ASC 965, Plan Accounting — Health and Welfare Benefit Plans

BDO INSIGHTS — DEFERRED COMPENSATION VEHICLES AND RABBI TRUSTS

Deferred compensation vehicles, including rabbi trusts, are in the scope of the consolidation guidance. A rabbi trust is a tax-advantageous, nonqualified trust that holds assets contributed by an employer to benefit an employee. Once the employer contributes assets to a rabbi trust, it generally cannot remove them except in case of bankruptcy. A rabbi trust generally measures its investments and its liabilities to employees at the same amount. It generally is a VIE because it has insufficient equity at risk (see Section 3.2).

Generally, a reporting entity that sponsors a rabbi trust is the trust’s primary beneficiary because it makes the decisions about the activities that most significantly affect the trust’s economic performance; for example, decisions about investment strategy and funding. The reporting entity generally has economics in the rabbi trust because it has a call option on the trust’s assets if it files for bankruptcy. However, reaching a conclusion about whether any party controls a rabbi trust requires the application of professional judgment based on the facts and circumstances. See Section 6.4.4 when the rabbi trust is not a VIE, which we believe would be rare.

1.3.2 Investment Companies

FASB REFERENCES

ASC 810-10-15-12(d), ASC 946-10-15-4 through 15-9, and ASC 946-10-55-1 through 55-46

An investment company (that is, a fund) in the scope of ASC 946 generally is outside the scope of the consolidation guidance; it does not consolidate its investments. Instead, an investment company generally accounts for its investments (including controlled investees) at fair value, except as shown in the following table.

LEGAL ENTITY / REPORTING ENTITY	PORTFOLIO INVESTEE (NOT AN INVESTMENT COMPANY)	INVESTMENT COMPANY IN THE SCOPE OF ASC 946	ENTITY PROVIDING SERVICES TO THE REPORTING ENTITY
INVESTMENT COMPANY IN THE SCOPE OF ASC 946	Outside the scope of ASC 810; apply ASC 946 (measure at fair value).	Based on the facts and circumstances (see Section 1.3.2.2).	In the scope of ASC 810 (see Section 1.3.2.2).
NOT AN INVESTMENT COMPANY	In the scope of ASC 810 (see Section 1.3.2.3).		

To be an investment company as defined in U.S. GAAP, a legal entity **must** have specific fundamental characteristics and may have other typical characteristics identified in ASC 946, as shown in the table below. The absence of a typical characteristic does not prevent a legal entity from being an investment company; all facts and circumstances are evaluated. A legal entity regulated under the 1940 Act is always an investment company.

FUNDAMENTAL (REQUIRED) CHARACTERISTICS	TYPICAL (NOT DETERMINATIVE) CHARACTERISTICS
▶ It obtains funds from one or more investors and provides the investors with investment management services ▶ It commits to its investors that its business purpose and only substantive activities are investing the funds for returns from capital appreciation, investment income, or both ▶ It does not receive (or have the objective of receiving) returns, benefits, or economics from an investee other than those normally attributable to ownership interests or that are other than capital appreciation or investment income	▶ It has more than one investment ▶ It has more than one investor ▶ It has investors that are not related parties of the parent or investment manager ▶ Its ownership interests are in shares, partnership units, or other equity instruments ▶ It manages substantially all its investments based on fair value

1.3.2.1 Investment Companies Evaluating Other Investment Companies

FASB REFERENCES

ASC 810-10-15-12(d)

An investment company must select an accounting policy to determine which investment companies to consolidate.

1.3.2.1.1 Reporting Entity Is a Business Development Company or Registered Investment Company

An investment company that is a business development company or registered fund must consider the SEC staff guidance below when determining whether to consolidate another investment company.

SEC STAFF GUIDANCE

SEC's Division of Investment Management Guidance Update No. 2014-11

Regulation S-X 3A-02 states: "*There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one entity directly or indirectly has a controlling financial interest in another entity.*"

Feeder Funds and Fund of Funds

Update No. 2014-11 acknowledges the guidance in Regulation S-X 3A-02, but states that for feeder funds, generally, the SEC staff has taken the position that unconsolidated financial statements are most meaningful, if, among other things: the feeder fund attaches the financial statements of the master fund to its financial statements and other conditions are present (which are discussed further in Update No. 2014-11). The SEC staff reached a similar conclusion for a fund of funds: unconsolidated financial statements are more meaningful to investors.[2]

Wholly Owned Subsidiaries

According to Update No. 2014-11, the SEC staff generally suggests that business development companies (BDCs) consolidate specific wholly-owned holding companies because "*consolidation provides investors with the most meaningful financial presentation in those statements*" when the holding company's purpose and design is to "*act as extension of the BDC's investment operations and facilitate the execution of the BDC's investment strategy.*" In the SEC staff's view, a registered investment company in similar circumstances also should consolidate its wholly owned subsidiaries; for example, a wholly owned subsidiary used as a blocker entity. In this context, the term "wholly owned" includes legal entities for which the reporting entity holds substantially all the voting shares.

1.3.2.1.2 Reporting Entity Is a Nonregistered Investment Company

BDO INSIGHTS — NONREGISTERED INVESTMENT COMPANIES' INVESTMENTS IN OTHER INVESTMENT COMPANIES

In Update No. 2014-11 (see Section 1.3.2.2.1), the SEC staff effectively concluded that a legal entity that acts as an extension of a BDC's investment operations and facilitates the execution of the BDC's investment objectives and strategy as part of its purpose and design (and to fulfill the BDC's fundamental characteristics as an investment company) is also by extension an investment company.

Wholly Owned Subsidiaries

In practice, nonregistered investment companies generally consolidate wholly owned investment companies created as blocker entities for tax purposes, or as special purpose vehicle (SPVs) for investing in targeted investees (for example, portfolio companies). These wholly owned blockers or SPVs generally are considered investment companies because they are designed to fulfill the nonregistered investment company's investment objectives and strategy, making them an extension of the nonregistered investment company. They generally also have the same

[2] The SEC staff said, "*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.*"

investment manager as the nonregistered investment company (or the manager of the wholly owned blocker or SPV is a related party to the investment manager of the nonregistered investment company).

Substantially Wholly Owned Subsidiaries

Some nonregistered investment companies also have accounting policies to consolidate either:

- Substantially wholly owned investment companies that act as extensions of the nonregistered investment company's investment objectives and strategy, consistent with Update No. 2014-11 (see Section 1.3.2.2.1). The term "substantially wholly owned" is not defined in U.S. GAAP or Update No. 2014-11. Therefore, the investment company must define and consistently apply that term.
- All investment companies in which the nonregistered investment company has a controlling financial interest (applying the guidance in ASC 810).

An investment company must consistently apply its accounting policy.

1.3.2.2 Operating Entity Providing Services to an Investment Company

FASB REFERENCES

ASC 946-810-45-2 through 45-3

An investment company may have a controlling financial interest in a legal entity (operating entity) that provides services to the investment company (for example, an investment advisor or transfer agent). If so, the investment company consolidates that operating entity (instead of measuring its investment at fair value), because its purpose is to provide services to the investment company rather than to generate a gain on sale.

1.3.2.3 Other Entities Involved With an Investment Company

FASB REFERENCES

ASC 810-10-15-12(d)

A reporting entity that is not an investment company (for example, an asset manager, general partner, managing member, or other service provider to the investment company or its portfolio companies) is outside the scope of ASC 946. Therefore, it must apply ASC 810 beginning with the VIE model to determine whether it has a controlling financial interest in the investment company unless another scope exception applies.

1.3.3 Governmental Entities and Governmental Financing Entities

FASB REFERENCES

ASC 810-10-15-12(e)

A reporting entity does not consolidate a governmental entity or specific financing entities established by a governmental organization. Those governmental entities and financing entities are outside the scope of the consolidation guidance.

1.3.3.1 Characteristics of a Governmental Entity

Governmental entities can be general purpose (for example, states, cities, counties) or special purpose (for example, school districts, public transportation, airports). This table summarizes the characteristics of a governmental entity according to the AICPA's Audit and Accounting Guide, *State and Local Governments,* paragraphs 1.01-1.02.

REQUIRED CHARACTERISTICS	CHARACTERISTICS THAT ARE NOT DETERMINATIVE
Any of the following: ▶ A public corporation, that is, an artificial person, such as a municipality or a governmental corporation created for administering public affairs ▶ A body corporate and politic ▶ A legal entity with a popular election of officers or appointment (or approval) of a controlling majority of the organization's governing body by officials of one or more state or local governments ▶ A legal entity that can be unilaterally dissolved by a government, with the net assets reverting to the government ▶ A legal entity that can enact and enforce a tax levy ▶ An organization that can directly issue debt that pays interest exempt from federal taxation (however, the organization can rebut the conclusion that it is a governmental entity if it has no other characteristics and there is compelling supporting evidence)	▶ A legal entity incorporated as an NFP organization ▶ A legal entity exempt from federal income taxation in accordance with Internal Revenue Code (IRC) Section 501 ▶ An employee benefit plan subject to the Employee Retirement Income Security Act of 1974

1.3.3.2 Characteristics of a Governmental Financing Entity

FASB REFERENCES

ASC 810-10-15-12(e)

A governmental financing entity is outside the scope of the consolidation guidance unless it meets **both** of the following criteria:

- It is not a governmental organization
- It is used by the reporting entity to circumvent the VIE model

BDO INSIGHTS — GOVERNMENTAL FINANCING ENTITIES GENERALLY ARE OUTSIDE THE SCOPE OF THE VIE MODEL

In our experience, a governmental financing entity rarely meets both criteria. Generally, a governmental financing entity is not used to circumvent the VIE model because it serves a legitimate business purpose. Therefore, a governmental financing entity generally is outside the scope of the VIE model. However, reaching a conclusion requires the application of professional judgment based on the facts and circumstances (for example, the legal entity's purpose and design, the reporting entity's involvement at inception, the nature of variable interests).

1.3.4 Money Market Funds

FASB REFERENCES

ASC 810-10-15-12(f)

A reporting entity does not consolidate a registered fund that is required to comply with Rule 2a-7 of the 1940 Act (a money market fund) or a fund that complies or operates in accordance with similar requirements based on its purpose and design. Registered money market funds must invest in securities with minimal credit risk and a short duration and are subject to constraints related to credit risk and diversification.

To be considered similar[3] to a registered money market fund, a fund that is not required to comply with Rule 2a-7 of the 1940 Act must **both**:

- Allow investor redemptions daily
- Invest in high-quality, short-term securities with low credit risk to maintain the principal investment

In other words, the fund's portfolio quality, maturity, and diversification must all be similar to that of a registered money market fund to use this scope exception.

A reporting entity must disclose specified information if it uses this scope exception (see Section 8.3.1.2).

1.4 SCOPE EXCEPTIONS TO THE VIE MODEL

FASB REFERENCES

ASC 810-10-15-13 and 15-17

Some legal entities are in the scope of ASC 810 but outside the scope of the VIE model. That is, they are in the scope of the voting model and other guidance in ASC 810 (see Chapter 6):

- Most NFP entities (see Section 1.4.1)
- Separate accounts of life insurance reporting entities described in ASC 944 (see Section 1.4.2)
- Some legal entities created before December 31, 2003 (see Section 1.4.3)
- Businesses (as defined in ASC 805) that meet specific conditions (see Section 1.4.4)
- A legal entity under common control with a private company that elects the private company accounting alternative (see Section 1.4.5)

BDO INSIGHTS — ANALOGIES TO VIE SCOPE EXCEPTIONS ARE INAPPROPRIATE

We believe a reporting entity cannot analogize to the VIE scope exceptions. That is, we believe the VIE scope exceptions apply only to the specifically identified legal entities; a reporting entity must evaluate all other legal entities first using the VIE model.

[3] ASU 2015-02, paragraph BC82.

1.4.1 Not-for-Profit Entities

FASB REFERENCES

ASC 810-10-15-5, ASC 810-10-15-17(a), and ASC 810-10-20: Not-for-Profit Entity

When evaluating whether a reporting entity has a controlling financial interest in a legal entity, the applicable guidance varies depending on whether the reporting entity and legal entity are NFP entities, as shown in the table below.

A reporting entity that is an NFP entity applies ASC 958, including ASC 958-810, *Not-for-Profit Entities — Consolidation,* instead of the general guidance in ASC 810 to evaluate legal entities (both NFP and for profit) for potential consolidation. However, a for-profit subsidiary of an NFP entity cannot use this scope exception.

A for-profit reporting entity applies the voting model and general subsections in ASC 810 (see Section 6.4.1), not the VIE model, to evaluate whether it controls an NFP entity. However, if the NFP entity is used by the for-profit reporting entity to circumvent the VIE model, the VIE model applies. Despite the scope exception, an NFP entity that is a related party or de facto agent of a reporting entity is included in the evaluation when performing the related party tiebreaker (see Section 4.4.3), if applicable.

		LEGAL ENTITY	
		NOT-FOR-PROFIT	FOR-PROFIT
REPORTING ENTITY	NOT-FOR-PROFIT	▶ A reporting entity that is an NFP entity applies the consolidation guidance in ASC 958-810 to determine whether to consolidate a for-profit or NFP legal entity.	
	FOR-PROFIT	▶ Apply ASC 810 voting model (see Section 6.4.1) unless the NFP entity is used by the for-profit reporting entity to circumvent the VIE model (in which case, the VIE model applies).	▶ Apply ASC 810.

The following graphic summarizes the characteristics of an NFP entity (as defined in U.S. GAAP) and a legal entity that is not an NFP entity.

CHARACTERISTICS OF AN NFP ENTITY (MUST HAVE ALL CHARACTERISTICS)

- Receives contributions of significant resources from those who do not expect proportionate financial returns
- Operates other than to provide goods or services at a profit
- Does not have ownership interests like those of business entities

CHARACTERISTICS OF AN ENTITY THAT IS NOT AN NFP ENTITY

- Owned by investors
- Provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants (such as a mutual insurance entity, credit union, or a rural electric cooperative)
- Provides employee benefits (see Section 1.3.1)

Other definitions of the term “nonprofit” or “not-for-profit” are common but may or may not align with the definition in U.S. GAAP. For example, any IRC 501(c)(3) tax-exempt entity commonly is referred to as a nonprofit entity.

IRS GUIDANCE

To be tax-exempt under Section 501(c)(3) of the Internal Revenue Code, an organization must be organized and operated exclusively for exempt purposes set forth in the Section 501(c)(3), and none of its earnings may inure to any private shareholder or individual. In addition, it may not be an action organization, i.e., it may not attempt to influence legislation as a substantial part of its activities and it may not participate in any campaign activity for or against political candidates. Organizations described in Section 501(c)(3) are commonly referred to as charitable organizations. Organizations described in Section 501(c)(3), other than testing for public safety organizations, are eligible to receive tax-deductible contributions.

BDO INSIGHTS — EVALUATING WHETHER A LEGAL ENTITY MEETS THE U.S. GAAP DEFINITION OF AN NFP ENTITY

We believe a tax-exempt entity in compliance with IRC Section 501(c)(3) generally meets the definition of an NFP entity in U.S. GAAP. Depending on the facts and circumstances, other tax-exempt legal entities (including legal entities classified as tax-exempt in accordance with other subsections of IRC Section 501) may or may not meet the U.S. GAAP definition of an NFP entity. When determining whether a legal entity is an NFP entity, other characteristics that may be informative (but are not determinative) include whether the legal entity is incorporated as an NFP organization and presents financial statements similar to an NFP entity. Reaching a conclusion about whether a legal entity has the three characteristics in the definition of an NFP entity in U.S. GAAP requires the application of professional judgment based on the facts and circumstances.

BDO INSIGHTS — WHETHER AN NFP ENTITY IS USED TO CIRCUMVENT THE VIE MODEL

A legal entity with the characteristics of an NFP entity often serves a legitimate business purpose for its sponsor, which does not receive a financial return for its contributions. However, reaching a conclusion about whether a reporting entity is using an NFP entity to circumvent the VIE model requires the application of professional judgment based on the facts and circumstances (for example, the NFP entity’s purpose and design, the reporting entity’s involvement at inception, the nature of variable interests).

1.4.2 Separate Accounts of a Life Insurance Reporting Entity

FASB REFERENCES

ASC 810-10-15-17(b) and ASC 944-80-45-1

The separate accounts of a life insurance reporting entity, as described in ASC 944, are not in the scope of the VIE model when evaluated by that reporting entity because ASC 944 already has presentation guidance for life insurance reporting entities. However, if a separate account of a life insurance entity prepares financial statements, it determines whether other legal entities with which it is involved are in the scope of the VIE model (unless another scope exception applies, such as the scope exception for investment companies (see Section 1.3.2)).

1.4.3 Legal Entities Created Before 2003

FASB REFERENCES

ASC 810-10-15-17(c) and ASC 810-10-30-7 through 30-9

A VIE or potential VIE created before December 31, 2003 is outside the scope of the VIE model if, after an exhaustive effort, the reporting entity cannot get the information necessary to:

- Determine whether the legal entity is a VIE
- Determine whether the reporting entity is the primary beneficiary
- Consolidate the VIE

A reporting entity generally can get the necessary information to make these determinations, especially if it participated significantly in the legal entity's design or redesign. This scope exception applies only if the reporting entity cannot get the necessary information to make these determinations.

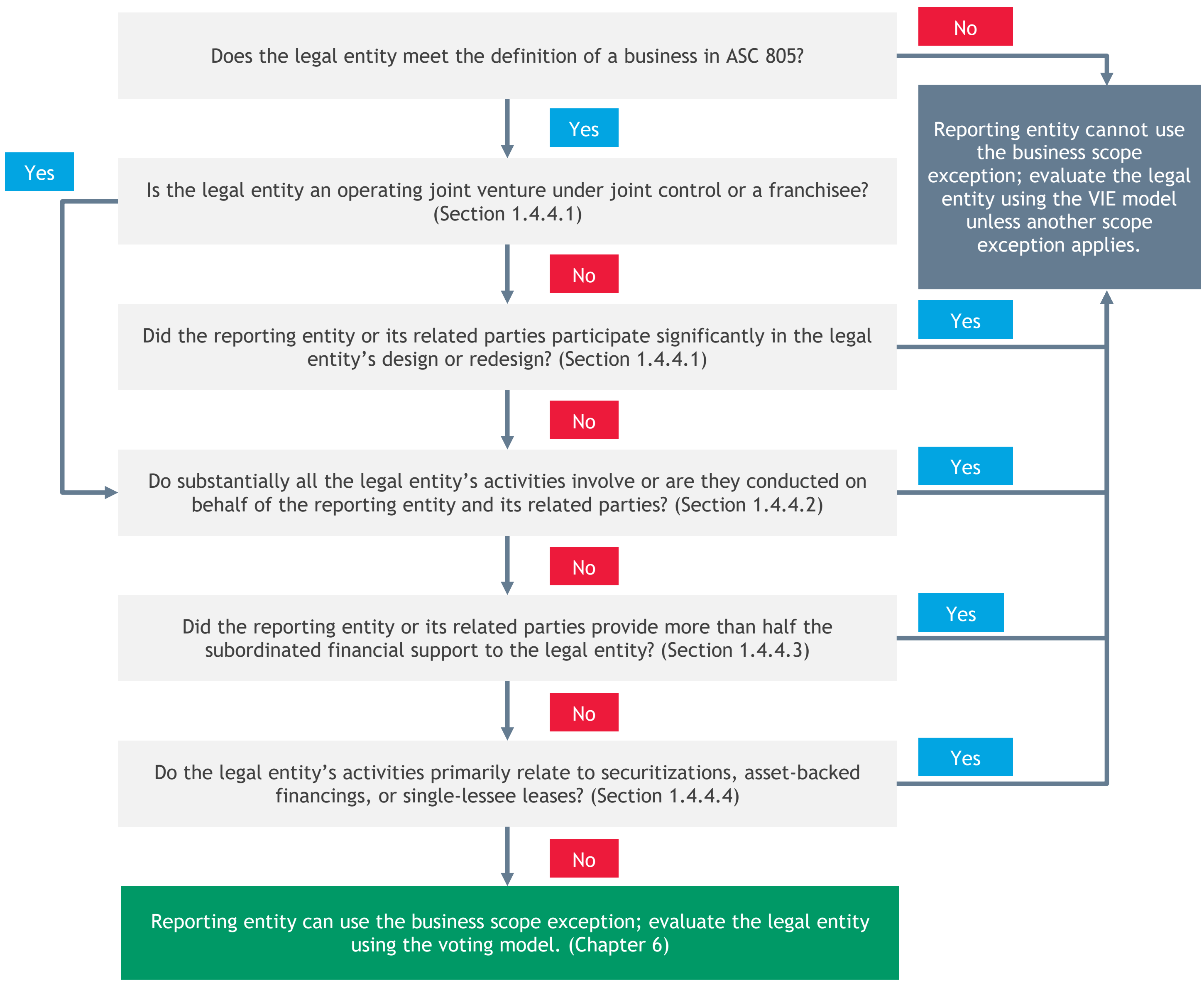
A reporting entity is required to disclose additional information if it uses this scope exception (see Section 8.3.1.3). If a reporting entity later gets the information to apply the VIE model to a legal entity and determines that the legal entity is a VIE, it applies specific initial measurement guidance in ASC 810.

1.4.4 Business Scope Exception

FASB REFERENCES

ASC 805-10-55-3A through 55-9, ASC 810-10-15-17(d), and ASC 810-10-20: Business

The VIE model has a scope exception for a legal entity that meets the definition of a business in ASC 805 (which could be met by using the "screen" test discussed in ASC 805-10-55-5A through 55-5C). However, to qualify for the business scope exception, the reporting entity also must satisfy all the conditions in the flowchart. These steps need not be performed in the order shown; if one condition is not met, the reporting entity does not evaluate whether the legal entity meets the definition of a business, or the other conditions.



A legal entity that was not previously evaluated to determine if it was a VIE because the business scope exception applied is not reevaluated in future periods, as long as it continues to meet these conditions.

BDO INSIGHTS — APPLYING THE BUSINESS SCOPE EXCEPTION

In our experience, although many legal entities meet the definition of a business (including by using the screen test), they rarely meet all the conditions for the VIE scope exception to apply. We believe a reporting entity should evaluate whether the business scope exception applies when it first becomes involved with the legal entity, as well as upon a reconsideration event (see Section 3.7). Reaching a conclusion that the business scope exception applies requires the application of professional judgment based on the facts and circumstances.

1.4.4.1 Participation in the Design or Redesign of the Business

FASB REFERENCES

ASC 323-10-20: Corporate Joint Venture, ASC 810-10-15-17(d)(1), ASC 845-10-S99-2, and ASC Master Glossary: Joint Venture and Franchise Agreement

If the reporting entity, its related parties, or its de facto agents participated significantly in the legal entity's design or redesign, the reporting entity cannot use the business scope exception. To make this determination, all facts and circumstances must be considered. For example, if the legal entity's governing documents were amended concurrently with the involvement of new parties, they generally are considered to be involved in designing or redesigning the legal entity. Generally, the fewer parties involved with a legal entity, the more likely that they are involved in its design or redesign.

When evaluating this condition, de facto agents do **not** include a party that cannot sell, transfer, or encumber its interests in a potential VIE without another party's approval (see Section 5.3.4). See Chapter 5 for guidance on identifying related parties and de facto agents.

This condition does not apply if the legal entity is an operating joint venture under joint control or a franchisee. That said, the exclusion for joint ventures and franchisees only applies to this condition; a reporting entity must still evaluate all other conditions for joint ventures and franchisees. A reporting entity cannot analogize to scope exceptions from the VIE model. Therefore, if a legal entity is not a joint venture or franchisee and the reporting entity participated significantly in the legal entity's design or redesign, the reporting entity cannot apply the business scope exception.

BDO INSIGHTS — DEFINITION OF A JOINT VENTURE

The scope exception in ASC 810 does not define the term "joint venture." However, the terms "joint venture" and "corporate joint venture" are defined elsewhere in U.S. GAAP, including in an exception from the general initial measurement requirements in ASC 810 (after adopting ASU 2023-05; see Section 7.2.4) when a joint venture reporting entity becomes the primary beneficiary of a VIE as part of the joint venture reporting entity's formation. We believe a reporting entity should use the same definition of a joint venture throughout its application of ASC 810.

We also believe that when evaluating whether a legal entity is an operating joint venture under joint control for the business scope exception, it must have the following characteristics:

- Joint control (unanimous consent) is required for decisions about all activities that most significantly impact the legal entity's economic performance (see Section 3.3.2.1) based on the legal entity's purpose and design (see Section 2.2.2.2).
- A small group of investors (the joint venturers) own and run the legal entity as a separate and specific business or project for their mutual benefit.

- Its purpose is to share risks and rewards in developing a new market, product, or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities.
- Each joint venturer directly or indirectly manages the joint venture (including through participation in its board of directors or through the substantive ability to remove an operator or manager). Therefore, joint venturers have an interest or relationship other than as passive investors.
- Ownership of a joint venture seldom changes, and the legal entity generally is a private company. However, a legal entity can still be a joint venture with a minority public ownership.

These characteristics stem from the definition of a joint venture in the Master Glossary and a statement from the SEC staff in ASC 845-10-S99-2 that it "*would object to a conclusion that joint control is the only defining characteristic of a joint venture*." Reaching a conclusion that a legal entity meets the definition of a joint venture requires the application of professional judgment based on the facts and circumstances.

JOINT VENTURE EXCEPTION RARELY APPLIES

Although the term "joint venture" is commonly used in practice, we believe the joint venture exception rarely applies. However, even if a legal entity does not meet the definition of a joint venture, it is not automatically consolidated by a reporting entity. If none of the scope exceptions from the VIE model apply, the reporting entity next evaluates whether it has a variable interest (see Chapter 2).

Examples 1-1 through 1-3 illustrate the evaluation of whether joint control exists.

EXAMPLE 1-1: EVALUATING JOINT CONTROL WHEN ONE PARTY MAKES DECISIONS FOR A SIGNIFICANT ACTIVITY

FACTS

- Investor A and Investor B formed a legal entity in which each investor owns 50% of the equity. The legal entity's purpose is to develop a new product combining a unique business and process owned by Investor A with a unique business and process owned by Investor B.
- The following activities most significantly impact the legal entity's economic performance:
  - Investor A and Investor B must unanimously agree on setting the annual budget.
  - Investor A unilaterally makes substantive decisions about the R&D activities (for example, how to combine the two processes to create the new product, entering and determining scope of contracts with third parties).

CONCLUSION

The legal entity is not a joint venture under joint control. Therefore, because the investors participated significantly in the legal entity's design, they may not use the business scope exception from the VIE model.

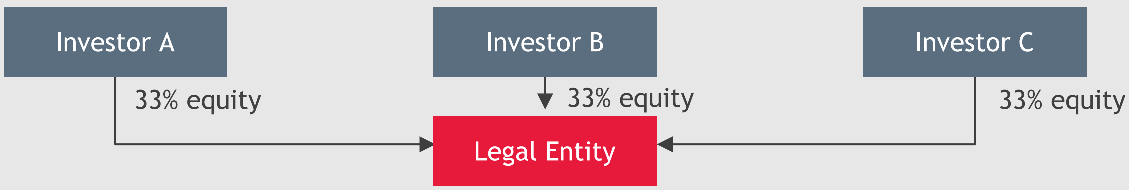
ANALYSIS

- For a legal entity to be a joint venture under joint control, we believe all decisions about the activities that most significantly impact the legal entity's economic performance must be subject to joint control (unanimous consent) and the legal entity must have all the other characteristics of a joint venture.
- Joint control does not exist because Investor A can unilaterally make decisions about R&D activities, which significantly impact the legal entity's economic performance.

EXAMPLE 1-2: EVALUATING JOINT CONTROL WHEN DECISIONS ARE MADE BY MAJORITY VOTE

FACTS

- Investor A, Investor B, and Investor C formed a legal entity, with ownership and voting percentages as shown.
- All decisions about the activities that most significantly impact the legal entity's economic performance are made by majority vote through equity interests.
- Investor A, Investor B, and Investor C are not related parties.



CONCLUSION

The legal entity is **not** an operating joint venture under joint control. Therefore, because the investors participated significantly in the legal entity's design, they may not use the business scope exception from the VIE model.

ANALYSIS

- For a legal entity to be a joint venture under joint control, we believe all decisions about the activities that most significantly impact the legal entity's economic performance must be subject to joint control (unanimous consent) and the legal entity must have all the other characteristics of a joint venture.
- Joint control does not exist because only a simple majority vote is required to make decisions about the activities that most significantly impact the legal entity's economic performance. Joint control exists only if unanimous consent is required.

EXAMPLE 1-3: EVALUATING JOINT CONTROL WHEN DECISIONS REQUIRE A SUPERMAJORITY

FACTS

- Assume the same facts as in Example 1-2, except all decisions about the activities that most significantly impact the legal entity's economic performance require 75% of the votes.
- Also assume the legal entity meets the other characteristics of a joint venture.

CONCLUSION

The legal entity is an operating joint venture under joint control. Therefore, the investors do not need to evaluate whether they participated significantly in the legal entity's design. However, they must evaluate whether the legal entity meets the other conditions for the business scope exception to apply (see flowchart in Section 1.4.4).

ANALYSIS

- For a legal entity to be a joint venture under joint control, we believe all decisions about the activities that most significantly impact the legal entity's economic performance must be subject to joint control (unanimous consent) and the legal entity must have all the other characteristics of a joint venture.
- All three investors must agree to reach the 75% voting threshold. Therefore, although the governing documents do not refer to unanimous consent, the legal entity is under joint control because unanimous consent is required for all decisions.

Example 1-4 illustrates the evaluation of whether joint control exists when a general partner, managing member, or operator is involved with the legal entity. In such cases, the reporting entity evaluates whether that general partner, managing member, or operator is **substantively** constrained by jointly agreed decisions of the other investors (see Section 3.3.2.1).

EXAMPLE 1-4: EVALUATING JOINT CONTROL WHEN A MANAGING MEMBER OR OPERATOR IS PRESENT

FACTS

- Investor A and Investor B formed a legal entity in which each investor own 50% of the equity. The legal entity's purpose is to develop a new product combining a unique business and process owned by Investor A with a unique business and process owned by Investor B.
- Investor A and Investor B must unanimously agree on all decisions about the activities that most significantly impact the legal entity's economic performance, which are setting a strategic plan for R&D activities and setting a detailed annual budget for the legal entity (including how much the legal entity can spend on R&D).
- Investor A also is the managing member (or operator) and as part of that role, executes decisions and oversees the legal entity's daily operations. However, the jointly agreed decisions substantively constrain how Investor A executes those decisions and its oversight responsibilities as managing member (or operator).
- The legal entity meets the other characteristics of a joint venture.

CONCLUSION

The legal entity is an operating joint venture under joint control. Therefore, the investors do not need to evaluate whether they participated significantly in the legal entity's design. However, they must evaluate whether the legal entity meets the other conditions for the business scope exception to apply (see flowchart in Section 1.4.4).

ANALYSIS

- For a legal entity to be a joint venture under joint control, we believe all decisions about the activities that most significantly impact the legal entity's economic performance must be subject to joint control (unanimous consent) and the legal entity must have all the other characteristics of a joint venture.
- Although Investor A executes decisions and oversees the legal entity's daily operations, it must act within the constraints of decisions made unanimously by Investor A and Investor B (see Section 3.3.2.1).
- Because all activities that most significantly impact the legal entity's economic performance are subject to joint control, and the legal entity has all the other characteristics of a joint venture, it is an operating joint venture under joint control.

1.4.4.2 Substantially All the Legal Entity's Activities Involve or Are Conducted on Behalf of the Reporting Entity

FASB REFERENCES

ASC 810-10-15-17(d)(2)

If the legal entity is designed so that substantially all its activities involve or are conducted on behalf of the reporting entity, its related parties, and its de facto agents (see Chapter 5), the reporting entity cannot use the business scope exception. The phrase "substantially all" is used several places in the VIE model and is evaluated qualitatively based on all facts and circumstances (see Section 3.6.2).

1.4.4.3 More Than Half the Subordinated Financial Support

FASB REFERENCES

ASC 810-10-15-17(d)(3) and ASC 810-10-20: Subordinated Financial Support

If the reporting entity and its related parties and de facto agents (see Chapter 5) provide more than half the total equity, subordinated debt, and other subordinated financial support to the legal entity, the reporting entity cannot use the business scope exception. The phrase “subordinated financial support” refers to variable interests that will absorb some or all of a VIE’s expected losses (see Section 2.2). The analysis is based on the fair values of variable interests in the legal entity, not their carrying amounts.

1.4.4.4 Activities Related to Leases or Securitizations

FASB REFERENCES

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

The reporting entity cannot use the business scope exception if the legal entity’s activities primarily relate to securitizations, asset-backed financings, or a single-lessee lease (regardless of its classification as an operating or a finance lease in accordance with ASC 842, *Leases*).

That said, the reporting entity does not automatically consolidate such a legal entity. If none of the scope exceptions from the VIE model (nor any of the consolidation scope exceptions) apply, the reporting entity next evaluates whether it has a variable interest in the legal entity and, if so, whether the legal entity is a VIE (see Chapter 2 and Chapter 3, respectively, for guidance). See Section 2.3.6 for guidance on determining whether a lease is a variable interest.

BDO INSIGHTS — PRIVATE COMPANY CONSIDERATIONS FOR A SINGLE-LESSEE LEGAL ENTITY

A reporting entity cannot use the business scope exception for a single-lessee legal entity and therefore must apply the VIE model (unless another scope exception applies). However, a private company (as defined in U.S. GAAP) may elect the private company accounting alternative and not apply the VIE model to the single-lessee legal entity and other eligible legal entities if specified conditions are met (see Section 1.4.5).

1.4.5 Private Company Accounting Alternative

FASB REFERENCES

ASC 810-10-15-17AC through 17AF

A reporting entity that is a private company (as defined in U.S. GAAP; see Section 1.4.5.1) may elect an accounting policy to not apply the VIE model to legal entities if all three conditions are met.

Neither the legal entity nor the common control parent(s) is a public business entity[a].	+	The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity (using only the voting model[b]).	+	The reporting entity and legal entity are under common control[c] (using only the voting model[b]).	=	The private company (reporting entity) may elect the private company accounting alternative.

(a) See Section 1.4.5.1 for the definition of a public business entity.
(b) See Chapter 6.
(c) See Section 1.4.5.2 for guidance on the term "common control" when evaluating the private company accounting alternative.

BDO INSIGHTS — APPLYING THE PRIVATE COMPANY ACCOUNTING ALTERNATIVE TO LIMITED PARTNERSHIPS

Limited partnerships and similar entities may not qualify for the private company alternative because the conditions above must be met, determined using only the voting model (see Section 1.4.5.2).

A reporting entity that elects the private company accounting alternative must:

- Consistently apply the policy to all legal entities that meet the three conditions above.
- Disclose specific information about legal entities for which the alternative is applied (see Section 8.3.1.4).
- Determine whether legal entities that do not meet the three conditions above are VIEs (for example, legal entities not under common control).

ACCOUNTING WHEN THE CRITERIA ARE NO LONGER MET

A private company reporting entity that becomes a public business entity (as defined in U.S. GAAP) can no longer apply the private company accounting alternative. Instead, it must apply all of ASC 810, including the VIE model, and no transition relief is available in that situation. Therefore, the reporting entity would account for such a change in accordance with ASC 250, *Accounting Changes and Error Corrections*, and would retrospectively adjust its financial statements for the effects of not applying the private company accounting alternative, which could be complex. Accordingly, a private company reporting entity should consider this possibility and the effort that would be involved when deciding whether to elect the alternative.

If the private company reporting entity elects the accounting alternative and remains a private company but later does not meet other conditions for applying the alternative (for example, the legal entity or common control parent becomes a public business entity), the private company reporting entity prospectively applies the VIE model from that date.

1.4.5.1 Definitions of Private Company and Public Business Entity

FASB REFERENCES

ASC 810-10-20: Private Company

An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

ASC 810-10-20: Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

The reporting entity must be a private company to elect the private company accounting alternative. Neither the legal entity being evaluated, nor the common control parent can be public business entities as defined in U.S. GAAP.

1.4.5.2 Common Control as Evaluated in the Private Company Accounting Alternative

FASB REFERENCES

ASC 810-10-15-17AC through 17AF

The private company accounting alternative applies only when a reporting entity that is a private company and a legal entity are under common control, considering only the voting model (see Section 1.4.5). However, U.S. GAAP does not define the term “common control.” Many private companies look to the views of the SEC staff (which were not codified because the Emerging Issue Task Force (EITF) did not reach a consensus) to define common control.

SEC STAFF GUIDANCE

EITF Abstract Issue No. 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141*, paragraph 3

> *The FASB staff understands that the SEC staff has indicated that common control exists between (or among) separate entities only in the following situations:*
>
> *a. An individual or enterprise holds more than 50 percent of the voting ownership interest of each entity.*
>
> *b. Immediate family members hold more than 50 percent of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert).*
>
> *(1) Immediate family members include a married couple and their children, but not the married couple's grandchildren*
>
> *(2) Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration regarding the substance of the ownership and voting relationships.*
>
> *c. A group of shareholders holds more than 50 percent of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities' shares in concert exists.*

BDO INSIGHTS — DEFINING COMMON CONTROL

A reporting entity generally should not extend the definition of common control beyond the immediate family member relationships described in EITF 02-5, paragraph 3(b). However, in issuing this private company accounting alternative, the FASB stated that it:

> *…continues to believe that the term common control should be broader than what the SEC observed in Issue 02-5. For example, an entity owned by a grandparent and an entity owned by a grandchild could, on the basis of facts and circumstances, be considered entities under common control for the purposes of applying the private company accounting alternative.* [4]

When evaluating whether the private company accounting alternative can be elected (or applied, if previously elected), common control is evaluated using the voting model. This differs from many other places in U.S. GAAP, in which common control is evaluated using both the VIE and voting models. Reaching a conclusion about whether common control exists when applying the private company accounting alternative requires the application of professional judgment based on the facts and circumstances.

[4] ASU 2018-17, paragraph BC19.

BDO INSIGHTS — WHETHER A GENERAL PARTNER CAN APPLY THE PRIVATE COMPANY ACCOUNTING ALTERNATIVE

A private company reporting entity must be under common control with the legal entity, determined using only the voting model, to elect the private company accounting alternative. However, the voting model is based on the premise that a reporting entity first considers the VIE model when evaluating control of a legal entity. As a result, determining whether the private company accounting alternative can be elected for a limited partnership can be complex because control of a limited partnership is determined based on kick-out rights. Specifically (and as discussed in Section 3.3.3):

- If a simple majority or lower percentage of the unrelated limited partners with equity at risk do not have substantive kick-out rights or participating rights, the limited partnership is a VIE.
  - If the general partner has economics (see Section 4.3), it controls the limited partnership **using the VIE model**.
  - If the general partner does not have economics, it does **not** control the limited partnership using the VIE model.
- If a simple majority or lower percentage of the unrelated limited partners with equity at risk have substantive kick-out rights or participating rights and the limited partnership does not have other characteristics of a VIE (see Chapter 3), the limited partnership is a voting interest entity. In the voting model:
  - If a limited partner (but not the general partner) has a majority of kick-out rights, it generally controls the limited partnership (see Section 6.3).
  - If no limited partner has a majority of kick-out rights, no party controls the limited partnership.

In other words, a general partner can have a controlling financial interest in a limited partnership only using the VIE model (not the voting model). Based on a technical inquiry with the FASB staff, we understand this also applies when evaluating whether the conditions are met for applying the private company accounting alternative.

As a result, in practice, a reporting entity often does not meet the conditions to apply the private company accounting alternative to a limited partnership (or LLC similar to a limited partnership), because the third condition often is not met (that is, the reporting entity and limited partnership often are not under common control, using only the voting model). Examples 1-6 and 1-7 illustrate two such scenarios, in which the private company accounting alternative cannot be applied.

Reaching a conclusion about whether common control exists requires the application of professional judgment based on the facts and circumstances.

1.4.5.3 Examples of the Private Company Accounting Alternative

FASB REFERENCES

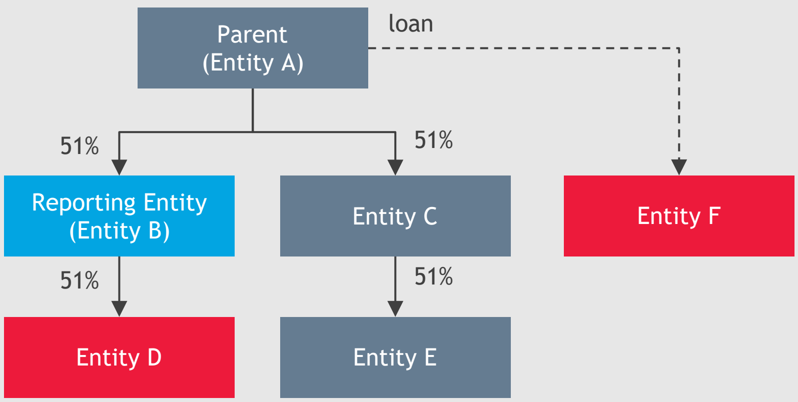
ASC 810-10-55-205AU through 55-205BF

Examples 1-5 through 1-7 illustrate the evaluation of whether a reporting entity can elect the private company accounting alternative (that is, whether the conditions discussed in Section 1.4.5 are met). Additional examples can be found in ASC 810-10-55-205BA through 55-205BF.

EXAMPLE 1-5 (ADAPTED FROM ASC 810-10-55-205AV THROUGH 55-AZ): PRIVATE COMPANY ACCOUNTING ALTERNATIVE — CORPORATION

FACTS

- Entities A (Parent), B (the reporting entity), C, D, E, and F (all corporations) are all private companies, not public business entities (as defined in U.S. GAAP), and the reporting entity has not previously elected the private company accounting alternative.
- Entity A holds a majority of the voting shares of Entities B and C. Entity B holds a majority of the voting shares of Entity D. Entity C holds a majority of the voting shares of Entity E. No circumstances indicate control does not rest with the majority owner.
- Entities A, B, C, D, and E do not directly or indirectly hold voting shares of Entity F. However, Entity A gave a loan to Entity F.



CONCLUSION

Entity B may elect the private company accounting alternative for Entities C and E. If elected, Entity B must apply the private company accounting alternative to all future legal entities that meet the conditions. Entity B may **not** elect the private company accounting alternative for Entities D and F. It instead must apply the VIE model to determine whether it has a controlling financial interest in those legal entities.

ANALYSIS

Entity B evaluates the conditions as sequenced in Section 1.4.5.

Neither the legal entity nor the common control parent(s) is a public business entity.

+

The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity (using only the voting model).

+

The reporting entity and legal entity are under common control (using only the voting model).

=

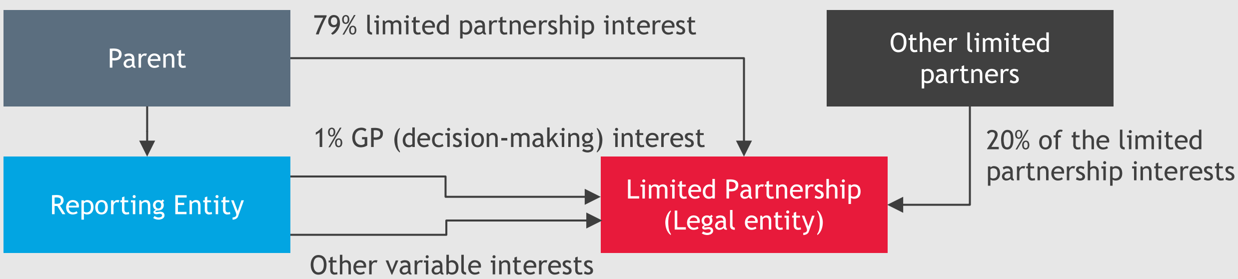
The private company (reporting entity) may elect the private company accounting alternative.

	CONDITION 1	CONDITION 2	CONDITION 3
Entity C	Met	Met: Entity B does not have a controlling financial interest in Entity C when using only the voting model.	Met: Entity A controls Entity B and Entity C because it holds a majority of shares of both entities; thus, Entity B and Entity C are under common control of Entity A using only the voting model.
Entity D	Met	**Not met**: Entity B has a controlling financial interest in Entity D using the voting model because it holds a majority of Entity D's voting shares.	Met: Entity A controls Entity B and indirectly controls Entity D (through its control of Entity B) using only the voting model because it holds a majority of shares of both entities; thus, Entity B and Entity D are under common control using the voting model.
Entity E	Met	Met: Entity B does not have a controlling financial interest in Entity E when using only the voting model.	Met: Entity A controls Entity B and indirectly controls Entity E (through its majority control of Entity C) using only the voting model because it holds a majority of shares of both entities; thus, Entity B and Entity E are under common control using the voting model.
Entity F	Met	Met: Entity B does not have a controlling financial interest in Entity F when using only the voting model.	**Not met**: Entity F is not under common control with Entity B using only the voting model because Entity A does not directly or indirectly hold a majority of Entity F's voting shares. Even if Entity F is a VIE and Entity A is its primary beneficiary, Entity F is not under common control with Entity B using only the voting model.

EXAMPLE 1-6: PRIVATE COMPANY ACCOUNTING ALTERNATIVE — REPORTING ENTITY IS THE GENERAL PARTNER

FACTS

- A parent (which could be a person or legal entity), the reporting entity, and a limited partnership (the legal entity) are all private companies, not public business entities (as defined in U.S. GAAP), and the reporting entity has not previously elected the private company accounting alternative.
- The parent has a controlling financial interest in the reporting entity using the voting model and holds 79% of the interests in the limited partnership. The reporting entity holds 1% of the economics and the general partnership interest (including decision-making rights). Unrelated parties hold the other limited partnership interests (20%).
- The reporting entity has a variable interest (for example, a loan) in the limited partnership.
- The limited partners with equity at risk do not have substantive kick-out rights or participating rights (see Sections 3.3.3.1 and 3.3.3.2, respectively).



CONCLUSION

The reporting entity cannot elect the private company accounting alternative for the limited partnership because the reporting entity and the limited partnership are not under common control using only the voting model. Therefore, unless another scope exception applies, the reporting entity first evaluates the limited partnership using the VIE model before considering the voting model.

ANALYSIS

The reporting entity evaluates the conditions as sequenced in Section 1.4.5:

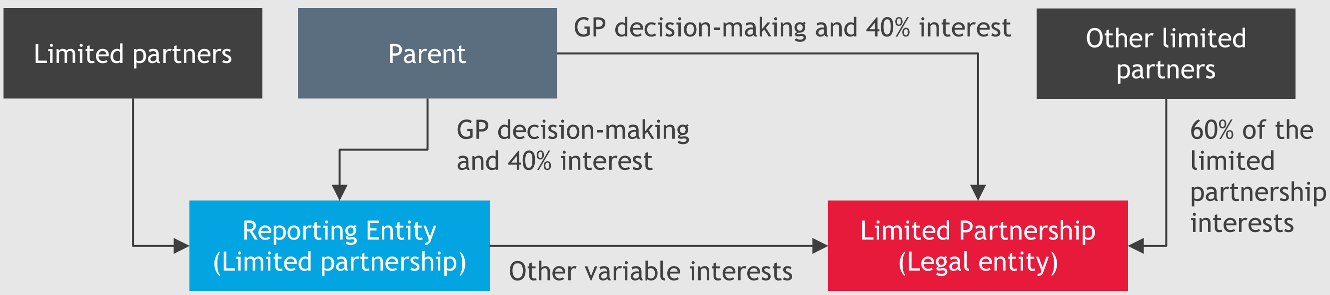
Neither the legal entity nor the common control parent(s) is a public business entity.	+	The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity (using only the voting model).	+	The reporting entity and legal entity are under common control (using only the voting model).	=	The private company (reporting entity) may elect the private company accounting alternative.

- The first condition is met. The parent and the limited partnership are private companies (and therefore not public business entities).
- The second condition is met. The reporting entity is the general partner, and a general partner does not control a limited partnership using only the voting model. A general partner can control a limited partnership only in the VIE model (see Sections 1.4.5.2 and 6.3).
- The third condition is **not** met. The parent does not control the limited partnership using only the voting model because it does not have a majority of the kick-out rights through voting interests (see Sections 1.4.5.2 and 6.3). Therefore, the reporting entity and the limited partnership are not under common control of the parent using only the voting model.

EXAMPLE 1-7: PRIVATE COMPANY ACCOUNTING ALTERNATIVE — PARENT IS THE GENERAL PARTNER IN A LIMITED PARTNERSHIP

FACTS

- A parent (which could be a person or legal entity), a reporting entity, and a limited partnership (the legal entity) are all private companies, not public business entities (as defined in U.S. GAAP), and the reporting entity has not previously elected the private company accounting alternative.
- The parent holds the general partnership interest and 40% of the limited partnership interests in both the reporting entity and the limited partnership.
- Unrelated parties hold the remaining partnership interests in the limited partnership (60%).
- The reporting entity has a variable interest (for example, a loan) in the limited partnership.
- The limited partners with equity at risk of the reporting entity and the limited partnership do not have substantive kick-out rights or participating rights (see Sections 3.3.3.1 and 3.3.3.2, respectively).

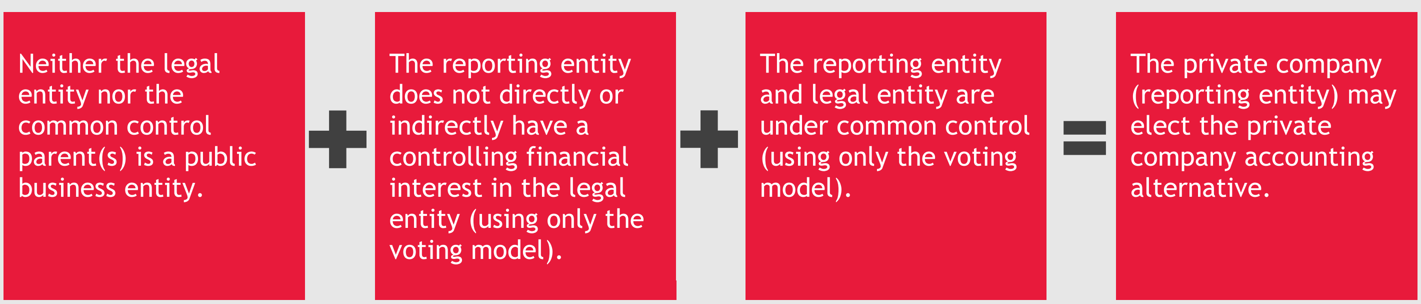


CONCLUSION

The reporting entity cannot elect the private company accounting alternative for the limited partnership because the reporting entity and the limited partnership are not under common control using only the voting model. Therefore, unless another scope exception applies, the reporting entity first evaluates the limited partnership using the VIE model before considering the voting model.

ANALYSIS

The reporting entity evaluates the conditions as sequenced in Section 1.4.5.



- The first condition is met. The parent and the limited partnership are private companies (and therefore not public business entities).
- The second condition is met. The reporting entity does not control the limited partnership using only the voting model because there are no substantive kick-out rights.
- The third condition is **not** met. The parent does not control the reporting entity or the limited partnership using only the voting model because it is the general partner. A general partner can control a limited partnership only in the VIE model (see Sections 1.4.5.2 and 6.3). Therefore, the reporting entity and the limited partnership are not under common control of the parent using only the voting model.

Chapter 2 — Identifying a Variable Interest

2.1 OVERVIEW

If a reporting entity cannot (or does not elect to) apply a consolidation or VIE scope exception, it next determines whether it has a variable interest in the legal entity. Variable interests are defined in ASC 810-10-20 as "*contractual, ownership, or other pecuniary interest in a VIE that change with changes in the fair value of the VIE's net assets exclusive of variable interests.*" A share of common stock is the simplest example of a variable interest. As the fair value of the legal entity's net assets increases or decreases, the common stock absorbs that change and increases or decreases in fair value.

A legal entity's assets and activities generally **create** variability and thus are not variable interests, while its liabilities and equity generally **absorb** variability and therefore are variable interests. Other contracts or arrangements, such as derivatives, are sometimes assets and sometimes liabilities. The role of a contract or arrangement in the legal entity's design dictates whether an interest creates or absorbs variability regardless of its legal form or accounting classification. Sometimes, determining whether an interest or arrangement is a variable interest is straightforward. Other times, the determination requires the application of professional judgment based on the facts and circumstances.

A reporting entity uses two steps to determine whether an interest or arrangement is a variable interest.

In Step 1, a reporting entity analyzes the nature of the legal entity's risks (for example, credit risk, equity price risk, and operations risk). Identifying the risks to which a legal entity is exposed requires the application of professional judgment based on the facts and circumstances.

In Step 2, the reporting entity gains an understanding of the legal entity's purpose and based on that purpose and the risks in the legal entity, it determines the variability the legal entity was designed to create and pass along to its interest holders. Formation documents, governing documents, marketing materials, and other contracts given to investors and other parties involved with the legal entity provide information about its purpose and design.

Variability is the difference from the expected outcome for the change in fair value of the legal entity's net assets. Expected variability refers to amounts derived from expected cash flows (probability-weighted estimated cash flows) and can be positive (expected residual returns) or negative (expected losses). Negative variability can occur without a history of losses and without anticipating a net loss in any of the expected outcomes. Even a profitable legal entity has expected losses. A reporting entity generally can qualitatively identify which factors contribute to the expected variability based on the legal entity's purpose and design. Although ASC 810 illustrates a quantitative approach for calculating expected losses and expected residual returns, a qualitative approach generally suffices (see Section 2.2).

Variable interests can be explicit or implicit. This table lists examples of potential explicit variable interests (it is not intended to be exhaustive).

POTENTIAL VARIABLE INTERESTS	GUIDANCE
Equity instruments	Section 2.3.1
Debt and beneficial interests	Section 2.3.2
Guarantees	Section 2.3.3
Derivatives and potential derivatives (including embedded derivatives, call options, put options, and forward contracts)	Section 2.3.4
Purchase or supply arrangements	Section 2.3.5
Leases	Section 2.3.6
Licenses and royalty arrangements	Section 2.3.7
Fees paid to a decision maker or service provider	Section 2.3.8

An interest in specified assets of a legal entity is a variable interest in that entity as a whole if **either** one of two conditions is met (see Section 2.4):

- The fair value of the specified assets is more than half the fair value of the VIE's assets
- The reporting entity has another variable interest in that entity as a whole (except for insignificant interests or interests with little variability)

A reporting entity with an interest in specified assets of a VIE treats part of the VIE as a deemed VIE (that is, as if it were a separate VIE, also called a "silo") if the specified assets are essentially the only source of payment for specified liabilities or specified other interests (see Section 2.5).

A reporting entity also must determine whether it has an implicit variable interest in a legal entity, which is described in ASC 810-10-25-51 as "*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*" (see Section 2.6).

2.2 HOW TO IDENTIFY A VARIABLE INTEREST

FASB REFERENCES

ASC 810-10-20: Subordinated Financial Support, Variable Interests, ASC 810-10-25-22, ASC 810-10-25-26, and ASC 810-10-55-17

Variable interests 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.*" Those changes in fair value occur because the legal entity is exposed to risks that affect its economic (cash flow) outcomes.

Risks → Changes in the fair value of net assets (expected losses and expected residual returns) → Changes absorbed by variable interests

A legal entity's assets and activities generally **create** variability and thus are not variable interests, while its liabilities and equity generally **absorb** variability and therefore are variable interests. Other contracts or arrangements, such as derivatives, may appear to both create and absorb variability because sometimes they are assets and sometimes they are liabilities. The role of a contract or arrangement in the legal entity's design dictates whether it creates or absorbs variability for the legal entity regardless of its legal form or accounting classification.

Collectively, variable interests that absorb some or all of a legal entity's expected losses are referred to as "subordinated financial support."

A reporting entity uses two steps to determine whether an interest or arrangement is a variable interest.

Step 1: Analyze the nature of the risks in the legal entity (Section 2.2.1) → Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders (Section 2.2.2)

2.2.1 Step 1: Analyze the Nature of the Risks in the Legal Entity

FASB REFERENCES

ASC 810-10-25-22 and ASC 810-10-25-24

A reporting entity uses two steps to identify variable interests.

Step 1: Analyze the nature of the risks in the legal entity → Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders (Section 2.2.2)

Several types of risks can cause variability, including:

Credit Risk	The potential that a counterparty (debtor) defaults on its obligations to repay the legal entity.
Interest Rate Risk	The potential that changes in interest rates affect the interest payments on floating-rate financial instruments or the fair value of fixed-rate financial instruments (see Section 2.2.2.3) issued or held by the legal entity.
Foreign Currency Exchange Risk	The potential that changes in foreign currency exchange rates affect cash flows from contracts denominated in a foreign currency issued by or held by the legal entity.
Commodity Price Risk	The potential that changes in the prices of commodities bought or sold by the legal entity affect the legal entity's cash flows.
Equity Price Risk	The potential for changes in the price (or fair value) of equity instruments held by the legal entity.
Operations Risk	The potential for changes in the operating revenues and costs incurred by the legal entity.

2.2.2 Step 2: Determine the Legal Entity's Purpose and the Variability It Was Designed to Distribute

FASB REFERENCES

ASC 810-10-25-22 through 25-23, ASC 810-10-25-26, ASC 810-10-25-29, ASC 810-10-55-19, and ASC 810-10-55-32

A reporting entity uses two steps to identify variable interests.

Step 1: Analyze the nature of the risks in the legal entity (Section 2.2.1)

Step 2: Determine the legal entity's purpose and the variability it was designed to create and pass along to its interest holders

Step 2 requires understanding the concepts of expected losses, expected residual returns, and expected variability (see Section 2.2.2.1). These concepts are crucial for identifying variable interests, determining whether a legal entity is a VIE, and identifying its primary beneficiary. A reporting entity generally can qualitatively identify which factors contribute to the expected variability based on the legal entity's purpose and design (see Section 2.2.2.2). Although ASC 810 illustrates a quantitative approach for calculating expected losses and expected residual returns, a qualitative approach generally suffices when identifying variable interests.

A legal entity's assets and activities generally **create** variability and thus are not variable interests, while its liabilities and equity generally **absorb** variability and therefore are variable interests. Other contracts or arrangements, such as derivatives, may appear to both create and absorb variability because sometimes they are assets and sometimes they are liabilities. The role of a contract or arrangement in the legal entity's design dictates whether it creates or absorbs variability for the legal entity regardless of its legal form or accounting classification.

2.2.2.1 Expected Losses, Expected Residual Returns, and Expected Variability

FASB REFERENCES

ASC 810-10-20: Expected Losses, Expected Residual Returns, and Expected Variability, and ASC 810-10-55-42 through 55-54

ASC 810 defines the following terms.

TERM	DEFINITION
Expected losses	*A VIE's expected losses are the expected negative variability in the fair value of its net assets exclusive of variable interests and not the anticipated amount or variability of the net income or loss.*
Expected residual returns	*A variable interest entity's (VIE's) expected residual returns are the expected positive variability in the fair value of its net assets exclusive of variable interests.*
Expected 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.*

Variability is the difference from the expected outcome for the change in fair value of the net assets. Expected variability refers to amounts derived from expected cash flows, discounted and adjusted for market factors and assumptions.

EVERY LEGAL ENTITY HAS EXPECTED LOSSES AND EXPECTED RESIDUAL RETURNS

Expected losses and expected residual returns do **not** refer to the expected variability in net income (loss) or the amount of net income (loss). Instead, these terms refer to the variability from the expected outcome for the change in fair value of the net assets. Therefore, a profitable legal entity still has expected losses, and an unprofitable legal entity still has expected residual returns (see Example 2 in ASC 810-10-55-50 through 55-54).

A reporting entity generally can qualitatively identify which factors contribute to expected variability based on the legal entity's purpose and design. Although ASC 810 illustrates a quantitative approach for estimating expected losses and expected residual returns, a qualitative approach generally suffices.

Whether qualitatively or quantitatively evaluating expected variability, the reporting entity considers different assumptions and probabilities for scenarios that could significantly impact the fair value of the legal entity's net assets. These assumptions and scenarios are identified and evaluated within the context of the legal entity's purpose and design.

To put these concepts into practice, it may be helpful to think about the legal entity's balance sheet on a fair value basis, which might include unrecognized assets (for example, internally generated intangible assets). The reporting entity would consider what risks (or activities) would cause changes in the fair values of those assets and liabilities, focusing on risks the legal entity was designed to create and pass along to its interest holders based on its purpose and design (see Section 2.2.2.2).

For example, if a legal entity is designed to own a factory that manufactures and sells widgets, the reporting entity considers operations risks related to the equipment, inventory, assembled workforce and their knowledge, the related processes, and how the fair value of the legal entity's assets would change in response to those risks. The equipment's fair value would likely decrease because of use or obsolescence, but the fair value of the inventory, raw materials, assembled workforce, and processes may change because of other factors, such as demand and competition. These operations risks will affect the legal entity's cash flows. Various scenarios within the context of the legal entity's purpose and design could cause the assets' fair values to increase or decrease, resulting in expected residual returns and expected losses, respectively (which together comprise the expected variability). Equity is a variable interest because it absorbs the changes in the fair value of the legal entity's assets (that is, changes in the assets' fair values affect the equity's fair value).

However, changes in fair values that could result from scenarios that are not part of the legal entity's purpose and design are excluded from the expected losses and expected residual returns. For example, a reporting entity would exclude a scenario in which a hurricane hits the factory (even though that scenario would cause the fair values of the factory to decrease) if the legal entity were not designed to address that risk. Conversely, if the legal entity's equity were marketed to investors as an investment in a hurricane-safe factory, and the legal entity was intended to protect investors from that risk, the possibility of a hurricane would be considered part of the legal entity's purpose and design.

Although a qualitative approach generally suffices to identify expected variability, in the rare cases when it is necessary to quantify the expected losses and expected residual returns, the reporting entity would estimate the expected variability in expected cash flows. ASC 810 demonstrates two acceptable approaches in ASC 810-10-55-42 through 55-54 (see also Appendix A).

2.2.2.2 Understanding Purpose and Design

FASB REFERENCES

ASC 810-10-25-25, ASC 810-10-25-27, ASC 810-10-25-31 through 25-32, ASC 810-10-25-37, and ASC 810-10-55-75 through 55-77

When identifying the risks that a legal entity was designed to create and pass along to its interest holders, understanding the legal entity's purpose is important. The reporting entity considers the facts and circumstances, including the items in graphic.

The reporting entity must review the terms of all formation documents, governing documents, marketing materials, and other contracts given to investors and other parties involved with the legal entity, such as:

- Articles of incorporation and bylaws, partnership agreements, etc.
- Guarantees, loans, and leases
- Operating, management, or decision-making agreements (for example, agreements for investment management or advisory services)

A reporting entity generally can qualitatively determine the variability a legal entity was designed to create and pass along to its interest holders, considering factors such as those listed below.

Nature of interests and contract terms	If the nature and terms of the legal entity's interests and contracts transfer all or part of the risk or return (or both) of the legal entity's assets or activities to holders of those interests, that is a strong indicator of the variability the legal entity is designed to create and pass along to its interest holders.

Subordination (priority on legal claims to the legal entity's cash flows)	The variability absorbed by a substantive subordinated interest is a strong indicator of the variability the legal entity is designed to create and pass along to its interest holders. ▶ The greater the subordinated interests compared to senior interests and the legal entity's expected losses and residual returns, the more likely the subordination is substantive. ▶ Subordinated interests generally absorb expected losses before senior interests. Therefore, a senior interest generally has a higher credit rating and lower interest rate than a subordinated interest. The greater the difference in credit ratings and interest rates, the more likely the subordination is substantive. ▶ Equity at risk (see Section 3.2.2) may be substantive even if the equity is insufficient (see Section 3.2.3).

Identifying the risks to which a legal entity was designed to be exposed requires the application of professional judgment based on the facts and circumstances.

A reporting entity evaluates whether it has a variable interest in a legal entity when it becomes involved with the legal entity, which may be after its formation. When obtaining an understanding of the legal entity's purpose and design and applying the VIE model, it may be necessary to determine whether potential future activities are part of its **current** purpose and design, or whether such changes would require reconsideration of whether the legal entity is a VIE (see Section 3.7).

The following table contrasts examples to illustrate the determination of whether a potential future activity is part of the legal entity's current purpose and design. These examples are illustrative, not determinative. Reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

ACTIVITY	FACTS AND CIRCUMSTANCES INDICATE ACTIVITY IS PART OF THE LEGAL ENTITY'S PURPOSE AND DESIGN	FACTS AND CIRCUMSTANCES INDICATE ACTIVITY IS NOT PART OF THE LEGAL ENTITY'S PURPOSE AND DESIGN
Buying or selling real estate (or other assets)	A legal entity was formed to buy, develop, and sell real estate, and that purpose is stated in the governing documents, the marketing materials, and cash flow projections presented to potential investors.	A legal entity was formed with real estate contributed at inception. The governing documents are silent on the legal entity's ability to buy or sell real estate. The marketing materials and cash flow projections presented to potential investors showed cash flows related only to the real estate contributed at inception and did not discuss buying or selling other real estate.
Entering a new line of business	A legal entity in the software industry plans to develop or buy new software that it will use to provide new services to customers in several industries. The marketing materials presented to potential new investors describe how the legal entity plans to develop this software internally and buy complementary businesses. The legal entity also has a history of acquisitions.	A legal entity operates in a mature manufacturing industry in which its new products are complementary to existing products and generally sold to the same population of customers. Although the governing documents allow the legal entity to enter a new line of business (subject to rights held by the investors), the marketing materials and cash flow projections presented to potential new investors show cash flows related only to the existing lines of business.
Making capital calls for more equity contributions	A legal entity in the business of oil and gas exploration is designed to extract resources from a specific geographic area. The marketing materials and cash flow projections show that the initial investors are expected to periodically contribute more cash to extract the resources from the targeted area.	A legal entity in the business of oil and gas exploration is designed to extract resources from a specific geographic area. Although the governing documents allow the legal entity to call more capital from investors, the marketing materials and cash flow projections presented to potential investors show that the initial contribution is expected to be sufficient to extract the resources from the targeted area. The purpose of allowing capital calls is to: ▶ Give flexibility in the unexpected event that changes in environmental legislation affect the manner and cost of extracting resources. ▶ Allow the investors to target other areas without forming a new legal entity; however, no such targets are currently contemplated.

Example 2-1 illustrates the identification of variable interests that absorb operations risk.

EXAMPLE 2-1 (ADAPTED FROM ASC 810-10-55-75 THROUGH 55-77): ABSORBING VARIABILITY FROM A RETAILER

FACTS

- A manufacturer and a strategic investor formed a legal entity to sell goods to customers in a new country.
- The legal entity was financed with $100 of equity contributed by the manufacturer and $3 million of 10-year fixed-rate debt financed by the strategic investor.
- Interest payments are due in priority before funds are available to the equity holder (the manufacturer).
- The manufacturer guarantees the fixed-rate debt to the strategic investor.

CONCLUSION

The legal entity was designed to create and pass operations risk to its interest holders, which are the debt investors (the strategic investor), the equity investor (the manufacturer), and the guarantor (the manufacturer). See Example 4-27 for the identification of the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The legal entity is exposed to operations risk (including sales volume risk, retail price risk, inventory price risk, and other operating cost risks).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The legal entity's purpose and design is to create and pass along operations risk to its interest holders, enable the manufacturer to extend its business into a new country, and earn a return for the strategic investor on its investment.
  - The equity is a variable interest because it absorbs variability created by the operations risk. Although the equity does not absorb expected losses greater than its fair value of $100, it absorbs expected residual returns from increases in the fair value of the legal entity's net assets.
  - The debt is a variable interest because it absorbs variability created by the operations risk and the equity is insufficient to absorb the legal entity's expected losses.
  - The guarantee is a variable interest because it is subordinate to the fixed-rate debt and therefore absorbs variability created by the operations risk.

2.2.2.3 Interest Rate Risk

FASB REFERENCES

ASC 810-10-25-33, ASC 810-10-55-59 through 55-61, and ASC 810-10-55-68 through 55-70

The risk of changes in interest rates may affect the fair value of a legal entity's net assets. Generally, when interest rate risk is present, the legal entity is also exposed to prepayment risk.

However, only some legal entities are designed to create and pass along interest rate risk (including prepayment risk). When determining whether interest rate risk is a risk the legal entity was designed to create and pass along to its interest holders, consideration is given to the legal entity's purpose and design, including the nature of its interests (such as debt and equity) and the terms of its contracts (see Section 2.2.2.2). When gaining an understanding of the legal entity's contracts, a reporting entity may identify mismatches between the terms of the legal entity's assets (such as its debt investments) and liabilities (such as debt it issued) related to maturities or interest rates (for example, fixed versus variable). Such mismatches often indicate the variability a legal entity was designed to create and pass along to its interest holders. The scenarios in the following table illustrate these concepts.

FACTS	ANALYSIS
A legal entity holds a portfolio of fixed-rate debt investments maturing in three years financed by issuing fixed-rate debt (maturing in three years) and equity.	The legal entity likely is **not** designed to be exposed to interest rate risk because there is no mismatch in maturities or interest rates between its debt investments and the debt it issued. However, the legal entity is likely designed to be exposed to credit risk.
A legal entity holds a portfolio of fixed-rate debt investments with contractual maturities ranging from six to eight years financed by issuing fixed-rate debt (maturing in three years) and equity.	The legal entity is likely designed to be exposed to interest rate risk related to changes in cash received upon sale of the fixed-rate debt investments, considering the mismatch in maturities between its debt investments and the debt it issued. The legal entity's purpose and design is to sell its debt investments before their contractual maturities to repay its own debt upon maturity. The sales proceeds will vary based partly on interest rates at the sale date, which will affect the returns to debt and equity holders. The legal entity also is likely designed to be exposed to credit risk. (See Example 2-2.)
A legal entity holds a portfolio of fixed-rate debt investments maturing in three years financed by issuing floating-rate debt (maturing in three years) and equity.	The legal entity is likely designed to be exposed to interest rate risk from changes in the fair value of the fixed-rate interest payments, considering the mismatch in interest rates (fixed versus variable) between its debt investments and the debt it issued. The legal entity's purpose and design is to use the fixed interest received on its debt investments to pay the floating-rate interest on its own debt, which will depend on interest rates at those dates. The fixed return on its debt investments might be insufficient to pay the floating rate interest on its own debt. The legal entity is also likely designed to be exposed to credit risk. (See Example 2-3.)

Examples 2-2 and 2-3 illustrate the identification of which interests absorb the expected variability from credit risk and interest rate risk.

EXAMPLE 2-2 (ADAPTED FROM ASC 810-10-55-59 THROUGH 55-61): INTEREST RATE RISK

FACTS

- A legal entity was formed and financed with $96 million of fixed-rate debt that matures in three years and $4 million of equity. It used the proceeds to buy $100 million of B- and BB-rated fixed-rate bonds, with maturities ranging from six to eight years.
- In three years, the legal entity will sell the bonds and use the proceeds to repay the fixed-rate debt holders. It will pay any residual to the equity investors.
- The transaction was marketed to potential debt investors as an investment in a portfolio of below-investment-grade, fixed-rate bonds with a longer weighted-average maturity than the legal entity's own fixed-rate debt, with credit support from the equity.
- The equity absorbs the first-dollar loss related to credit risk and interest rate risk and receives any residual rewards from favorable changes in interest rates or credit risk that affect the cash received from selling the bonds.

CONCLUSION

The legal entity is designed to create and pass along the following risks to its variable interest holders, which are the debt and equity investors:

- Credit risk from potential defaults on principal and interest payments by the bond issuers.
- Interest rate risk from changes in cash received upon sale of the bonds before maturity.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - Credit risk from potential defaults on principal and interest payments by the bond issuers.
  - Interest rate risk from interim changes in the fair value of the fixed-rate periodic interest received on the bonds.
  - Interest rate risk from changes in cash received upon sale of the bonds before maturity.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The legal entity's purpose and design is to expose debt investors to credit risk on bonds in the portfolio and to changes in the bonds' fair value during its three-year life caused by interest rate fluctuations (considering the mismatch in maturities between the bonds and debt issued). The equity absorbs the first-dollar loss. Substantive subordination exists for these risks.
  - Based on the nature and terms of the legal entity's debt and equity, the legal entity was not designed to create and pass along interest rate risk from interim changes in the fair value of the fixed-rate periodic interest received on the bonds.

EXAMPLE 2-3 (ADAPTED FROM ASC 810-10-55-68 THROUGH 55-70): LEGAL ENTITY PRIMARILY FINANCED BY FLOATING-RATE DEBT, WHICH HOLDS INVESTMENTS IN FIXED-RATE SECURITIES

FACTS

- A legal entity was formed and financed with $90 million of floating-rate debt that matures in three years and $10 million of equity. It used the proceeds to buy $100 million of AAA-rated fixed-rate bonds, which mature in three years.
- The legal entity will use the fixed interest received on the bonds to pay the floating-rate interest to the debt investors and will pay any residual to the equity investors. In three years, the bonds will mature, and the legal entity will use the proceeds to repay the floating-rate debt holders. It will pay any residual to the equity investors. The legal entity is not actively managed.
- The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality, fixed-rate bonds. The equity absorbs the first-dollar loss if a credit default occurs or if the fixed-rate return on the bonds is insufficient to pay the floating-rate interest on the debt.

CONCLUSION

The legal entity is designed to create and pass along the following risks to its variable interest holders, which are the debt and equity investors:

- Credit risk from potential defaults on principal and interest payments by the bond issuers.
- Interest rate risk from mismatches between the fixed-rate bonds and floating-rate debt.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.

- Credit risk from potential defaults on principal and interest payments by the bond issuers.
- Interest rate risk from mismatches between the fixed-rate bonds and floating-rate debt.

▶ Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders:

- The legal entity's purpose and design is to expose debt and equity investors to credit risk and to interest rate risk from mismatches between the fixed-rate bonds and floating-rate debt.

2.3 EXPLICIT VARIABLE INTERESTS

FASB REFERENCES

ASC 810-10-20: Variable Interests and ASC 810-10-55-20

Variable interests 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.*" Explicit variable interests arise from contractual terms and arrangements. This table lists examples of potential explicit variable interests (it is not exhaustive).

POTENTIAL VARIABLE INTERESTS	GUIDANCE
Equity instruments	Section 2.3.1
Debt and beneficial interests	Section 2.3.2
Guarantees	Section 2.3.3
Derivatives and potential derivatives (including embedded derivatives, call options, put options, and forward contracts)	Section 2.3.4
Purchase or supply arrangements	Section 2.3.5
Leases	Section 2.3.6
Licenses and royalty arrangements	Section 2.3.7
Fees paid to a decision maker or service provider	Section 2.3.8

2.3.1 Equity Instruments

FASB REFERENCES

ASC 810-10-55-22

Equity generally is a variable interest because it is an ownership interest in the legal entity whose value generally absorbs changes in the fair value of the legal entity's net assets. However, reaching a conclusion about whether equity is a variable interest depends on whether the equity is "at risk" (see Section 3.2.2) as follows:

The equity is at risk	Equity at risk is a variable interest.
The equity is **not** at risk	Equity that is not at risk is a variable interest if it absorbs the legal entity's variability. ▶ If the equity absorbs expected residual returns, but not expected losses or vice versa (e.g., because of a liquidation preference), the equity generally is a variable interest. ▶ If equity held by a reporting entity absorbs variability the reporting entity itself created through the only asset in the legal entity, the equity is **not** a variable interest (see Section 2.3.1.1 for guidance on trust-preferred securities).

2.3.1.1 Trust-Preferred Securities

FASB REFERENCES

ASC 810-10-55-22

Equity held by the reporting entity that is not at risk may **not** be a variable interest if the reporting entity absorbs variability it creates itself (for example, variability related to the reporting entity's own credit risk). This fact pattern arises in some trust-preferred securities structures.

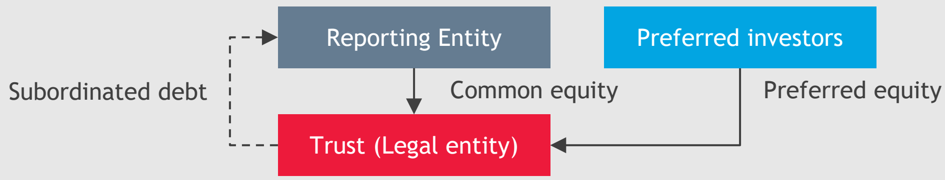
Example 2-4 illustrates the identification of which interests absorb the expected variability in a simplified trust-preferred security arrangement in which a reporting entity creates the expected variability. Other trust-preferred security arrangements may have different terms and features. Reaching a conclusion about whether a reporting entity is absorbing its own variability requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 2-4: TRUST-PREFERRED SECURITIES

FACTS

- A trust (the legal entity) was formed and financed with preferred equity.
- The reporting entity received cash and common equity from the trust in exchange for issuing subordinated debt (with stated maturity dates) to the trust, which the trust holds as its only asset.
- The reporting entity pays interest to the trust, which it pays to the preferred investors as preferred dividends.

- The trust must redeem its preferred equity upon maturity of the subordinated debt investment.



CONCLUSION

The preferred equity is a variable interest in the trust, but the common equity is not.

ANALYSIS

- The trust's purpose and design is to expose preferred investors to the reporting entity's credit risk. The preferred equity absorbs the trust's variability and therefore is a variable interest.
- The reporting entity creates variability by issuing subordinated debt to the trust, which is the trust's only asset, and the reporting entity absorbs its own variability through the common equity. The variability absorbed by the common equity depends on the reporting entity's own credit risk. An interest held by a reporting entity is not a variable interest if it absorbs variability the reporting entity creates.

2.3.1.2 Call Options on the Legal Entity's Equity

FASB REFERENCES

ASC 810-10-55-22 and ASC 810-10-55-29

While a call option on a legal entity's equity generally is not equity at risk (because it does not participate significantly in both profits and losses), the call option generally is a variable interest if its exercise price is at other than fair value.

"FAIR VALUE" IS NOT ALWAYS FAIR VALUE

A reporting entity may negotiate an exercise price intended to approximate fair value. The exercise price might be expressed as a formula and might even be referred to or defined as "fair value" in the agreement. However, such a formula is considered other than fair value because the value of the underlying might change over time compared to the stated formula.

2.3.2 Debt and Beneficial Interests

FASB REFERENCES

ASC 810-10-55-23 through 55-24

ASC 810 states that 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.*"

If a senior interest exists, the more subordinated interests absorb losses first. A senior interest generally has a higher credit rating and lower interest rate than a subordinated interest and may absorb little of a legal entity's expected variability. On the other hand, a higher interest rate and a lower credit rating may indicate that the debt holders or beneficial interest holders expect to absorb the legal entity's expected losses; a decrease in the fair value of a legal entity's assets is more likely to prevent the debt or beneficial interest from being repaid.

The greater the difference in the credit ratings and interest rates between two instruments, the more likely the subordination is substantive. Also, the greater the amount of the subordinated interests compared to the senior interests and to the legal entity's expected losses, the more likely the subordination is substantive.

BDO INSIGHTS — DEBT GENERALLY IS A VARIABLE INTEREST

We believe almost all debt issued by legal entities evaluated using the VIE model are variable interests because they generally absorb some of the legal entity's expected losses (that is, a decrease in the fair value of a legal entity's net assets). We believe reaching a different conclusion would be rare and would require the application of professional judgment based on the facts and circumstances (for example, evidence that it is the most senior debt and is rated as investment-grade by a ratings agency).

2.3.3 Guarantees

FASB REFERENCES

ASC 810-10-55-25 through 55-26

Guarantees of the value of a legal entity's assets or liabilities absorb variability if they protect other interest holders in the legal entity from suffering losses if it defaults on its obligations (that is, the guarantor must perform or pay if losses occur). The size of the premium or fees received by the guarantor is one indicator of the risk expected to be absorbed by the guarantor. Conversely, if the legal entity writes a guarantee, the guarantee creates variability and therefore is not a variable interest in the legal entity.

Counterparty guarantees the legal entity's obligations or assets	The guarantee absorbs variability. ▶ If the guarantee relates to obligations of the legal entity, it generally is a variable interest, for the same reasons debt is a variable interest (see Section 2.3.2). ▶ If the guarantee relates to assets, the reporting entity determines whether the guarantee is an interest in specified assets or a variable interest in that entity as a whole (see Section 2.4).
Legal entity is the guarantor	▶ The guarantee creates variability in the legal entity because it exposes the legal entity to risks if it must perform or pay. Therefore, the guarantee is **not** a variable interest in the guarantor legal entity. However, the legal entity needs to evaluate whether it has a variable interest in the counterparty that it is guaranteeing. ▶ A legal entity's (or its subsidiary's) guarantee of its own debt is not a variable interest because a legal entity cannot guarantee its own performance.

See Example 2-1 for a guarantee that is a variable interest.

As discussed in Section 2.6, an implicit variable interest exists when a reporting entity **indirectly** absorbs a legal entity's expected variability because of other arrangements, relationships, or facts and circumstances. A reporting entity should be alert for facts and circumstances indicating that an implicit guarantee exists.

2.3.4 Derivatives and Potential Derivatives

FASB REFERENCES

ASC 810-10-25-34 through 25-36 and ASC 810-10-55-29 through 55-32

A legal entity may enter a derivative contract to reduce the variability created by specific assets, activities, or mismatches between assets and liabilities, thereby protecting specific liability and equity holders from that variability. Derivatives can be an asset or a liability (recognized or unrecognized). While a legal entity's assets generally create variability and thus are not variable interests, some assets, such as some derivatives, are variable interests. A reporting entity must analyze the characteristics of a derivative to determine whether it is a variable interest:

- If the instrument exposes the legal entity to risks that increase (create) expected variability, the instrument is **not** a variable interest.
- If the instrument reduces (absorbs) the legal entity's exposure to risks that cause variability, the instrument is a variable interest.

The reporting entity follows a two-step process to make this determination.

Step 1: Does the derivative have creator characteristics?

Does the derivative have **both** of the following creator characteristics?

- 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).
- The derivative counterparty is senior in priority to, or equal in priority to the most senior class of, other interest holders in the legal entity.

No → It does not have both creator characteristics.

Further analysis is required to determine whether the derivative **is** an absorber of variability and **is** a variable interest.

Yes, it has both creator characteristics.

Step 2: Does the derivative fail the essentially all test?

Are the changes in the derivative's fair value or cash flows expected to offset all, or essentially all, the risk or return (or both) of a majority of the legal entity's assets (excluding the derivative) or activities?

No → The derivative does not offset essentially all the risk or return (or both) of a majority of the legal entity's assets. Therefore, it is not a variable interest.

Yes, essentially all the changes are offset.

Further analysis of the legal entity's design is required (using the steps in Section 2.2) to determine whether the derivative is an absorber of variability and is a variable interest.

See Section 2.3.4.2 for example evaluations of derivative instruments.

2.3.4.1 Embedded Derivatives

FASB REFERENCES

ASC 810-10-55-31

Some assets and liabilities of a legal entity have embedded derivatives. When identifying a variable interest, a reporting entity first determines the economic characteristics and risks of the embedded derivative, including whether its underlying is "clearly and closely" related to its host, using the guidance in ASC 815, *Derivatives and Hedging*.

Host Instrument — A contract or instrument with a derivative instrument embedded in it. For instruments issued in the form of shares, the reporting entity determines whether the host contract is more akin to debt or equity, which can be complex and requires the application of professional judgment based on the facts and circumstances.	Clearly and closely related?	**Underlying** — A variable that with either a notional amount or a payment provision, determines the settlement of a derivative instrument. For example, an underlying may be a specified interest rate, security price, commodity price, foreign exchange rate, or an index of prices or rates.

The embedded derivative and host **are** clearly and closely related when they have similar economic characteristics and risks; for example:

Host Instrument — Debt	Clearly and closely related	**Underlying** — non-leveraged interest rate, inflation, or creditworthiness
Host Instrument — Equity	Clearly and closely related	**Underlying** — price of a share in the entity

See BDO's publication, Complex Financial Instruments, for guidance on determining whether an embedded derivative is clearly and closely related to its host.

If the embedded derivative is clearly and closely related to its host…	The reporting entity does not separately evaluate the embedded derivative from its host as a potential variable interest.
If the embedded derivative is not clearly and closely related to its host…	The reporting entity separately evaluates the embedded derivative as a potential variable interest.

BDO INSIGHTS — DETERMINING WHETHER AN EMBEDDED DERIVATIVE IS A VARIABLE INTEREST

ASC 815 includes two other criteria that must be met to separate an embedded derivative from its host: (1) the embedded feature must meet the definition of a derivative; and (2) the host contract must not be remeasured at fair value at each balance sheet date with the changes in fair value recognized in earnings.

However, these criteria are irrelevant when identifying variable interests. An embedded derivative can still be a variable interest (separate from the host) even if the embedded derivative is not bifurcated from the host when applying ASC 815.

2.3.4.2 Example Evaluations of Derivative Instruments

FASB REFERENCES

ASC 810-10-55-25 through 55-28 and ASC 810-10-55-62 through 55-67

The following table (which is **not** determinative) describes several types of derivatives (or potential derivatives) and whether they generally absorb variability (are variable interests); or create variability (are not variable interests). However, all facts and circumstances must be evaluated before concluding.

TYPE OF DERIVATIVE	DESCRIPTION	CREATOR VS. ABSORBER	GUIDANCE
Call option on assets held by the counterparty	The counterparty can buy assets from the legal entity at other than fair value.	Absorber	Section 2.3.4.3
Call option on assets held by the legal entity	The legal entity can buy assets from the counterparty at other than fair value.	Creator	Section 2.3.4.3
Put option on assets held by the legal entity	The legal entity can sell assets to the counterparty at other than fair value.	Absorber	Section 2.3.4.4
Put option on assets held by the counterparty	The counterparty can sell assets to the legal entity at other than fair value.	Creator	Section 2.3.4.4
Forward sale on assets held by the legal entity	The legal entity must sell assets it owns to the counterparty at other than fair value.	Absorber	Section 2.3.4.5
Forward sale on assets not owned by the legal entity	The legal entity must sell assets it does not own to the counterparty at other than fair value.	Creator	Section 2.3.4.5
Forward purchase on assets held by the legal entity	The legal entity must buy assets from the counterparty at other than fair value.	Creator	Section 2.3.4.5

Examples 2-5 and 2-6 illustrate the determination of whether derivatives are variable interests.

EXAMPLE 2-5 (ADAPTED FROM ASC 810-10-55-62 THROUGH 55-64): LEGAL ENTITY PRIMARILY FINANCED BY FIXED-RATE DEBT, WHICH HOLDS INVESTMENTS IN LONGER-TERM FIXED- AND VARIABLE-RATE DEBT (WITH A FIXED-RATE SWAP)

FACTS

- A legal entity was formed and financed with $96 million of fixed-rate debt that matures in three years and $4 million of equity. It used the proceeds to buy:
  - $40 million of B- and BB-rated fixed-rate securities with maturities ranging from six to eight years.
  - $60 million of B- and BB-rated floating-rate securities with maturities ranging from six to eight years (average maturity of seven years).
- The legal entity also entered a swap with a bank with a $60 million notional, seven-year maturity date, to pay a floating interest rate and receive a fixed interest rate, which is designed to convert the $60 million of floating-rate securities to fixed-rate securities with the same average maturity.
- In three years, the legal entity will sell the securities, settle the swap in cash, and use the net proceeds to repay the fixed-rate debt holders. It will pay any residual to the equity investors.
- Net amounts payable to the swap counterparty periodically and in three years (if required) have priority over payments to debt holders and equity investors.
- The transaction was marketed to potential debt investors as an investment in a portfolio of below-investment-grade fixed- and floating-rate securities (with the floating rate swapped for fixed) with a longer weighted-average maturity (including the effect of the swap) than the legal entity's own fixed-rate debt, with credit support from the equity.
- The equity absorbs the first-dollar loss related to credit risk and interest rate risk and receives any residual returns from favorable changes in interest rates or credit risk.

CONCLUSION

The interest rate swap is not a variable interest. However, the debt and equity are variable interests.

ANALYSIS

The legal entity is exposed to the following risks:

- Credit risk from potential defaults on principal or interest received from the securities in the portfolio.
- Credit risk from a potential default by the swap counterparty on interest and any settlement due to the legal entity in three years.
- Interest rate risk from changes in the fair value of the fixed-rate interest received on fixed-rate securities in the portfolio and on the fixed leg of the swap.
- Interest rate risk from changes in the interest received on floating-rate securities in the portfolio.
- Interest rate risk from changes in cash received upon sale of the fixed-rate securities before maturity.
- Interest rate risk from the swap settlement in three years.

To identify the variable interests in the legal entity, the following facts and circumstances were evaluated:

- The legal entity was designed to create and pass along specific risks related to credit risk and interest rate risk to debt holders and equity investors.
- Based on the nature and terms of the contracts and interests, it was not designed to create and pass along interest rate risk from changes in:
  - The fair value of the fixed-rate interest received on the fixed-rate securities and on the fixed leg of the swap.
  - The interest received on the floating-rate securities.

Those facts and circumstances are evaluated using the steps in Section 2.3.4.

- Step 1: Does the derivative have both of the creator characteristics?
  - Yes. The interest rate swap has both of the creator characteristics: its underlying is based on observable market rates and it is senior in priority to other interest holders.
- Step 2: Does the derivative fail the essentially all test?
  - No. Although the swap's notional amount relates to a majority of the legal entity's assets, changes in the cash flows or the fair value of the swap are **not** expected to offset all, or essentially all, the risk or return related to those assets because the cash flows and fair value of the legal entity's assets are affected by other risk factors (that is, credit risk). Therefore, the derivative creates (instead of absorbing) variability and is not a variable interest.

EXAMPLE 2-6 (ADAPTED FROM ASC 810-10-55-65 THROUGH 67): LEGAL ENTITY PRIMARILY FINANCED BY FIXED-RATE DEBT, WHICH HOLDS INVESTMENTS IN FOREIGN-CURRENCY-DENOMINATED DEBT (WITH A CURRENCY SWAP)

FACTS

- A legal entity was formed and financed with $96 million of fixed-rate debt that matures in five years and $4 million of equity. It used the proceeds to buy a portfolio of $100 million of B- and BB-rated fixed-rate investments denominated in Japanese yen (JPY) maturing in five years.
- The legal entity also entered a cross-currency swap with a $100 million notional five-year pay-fixed JPY and receive-fixed U.S. dollars (USD), which is designed to effectively convert the fixed-rate JPY-denominated investments to fixed-rate USD investments, effectively offsetting the foreign exchange risk on the interest and the amount due upon maturity for the JPY-denominated investments. The swap is senior to the debt and equity.
- Upon the investments' maturity, the legal entity will pay or receive a final settlement on the swap and use the net proceeds to repay the fixed-rate debt holders. It will pay any residual to the equity investors.
- 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 from interest and principal repayment on the investments), with credit support from the equity.
- The equity absorbs the first-dollar loss and receives any residual returns.

CONCLUSION

The cross-currency swap is not a variable interest. However, the debt and equity are variable interests.

ANALYSIS

The legal entity is exposed to the following risks:

- Credit risk from potential defaults on the principal and interest on investments in the portfolio.
- Credit risk from a potential default by the cross-currency swap counterparty on interest and any settlement due in five years.
- Interest rate risk from changes in the fair value of the fixed-rate interest received on the fixed-rate investments and on the receive leg of the cross-currency swap.
- Foreign currency exchange risk from the interest received on the fixed-rate JPY-denominated investments and the receipt of principal at maturity.
- Foreign currency exchange risk from the interest payments or receipts and the final settlement of the cross-currency swap in five years.

To identify the variable interests in the legal entity, the following facts and circumstances were evaluated:

- The debt and equity are exposed to credit risk from potential defaults on investments in the portfolio and by the cross-currency swap counterparty, and therefore are variable interests.

- Based on the nature and terms of the legal entity's debt and equity, the legal entity's purpose and design was not to create and pass along interest rate risk from changes in the fair value of the fixed-rate interest received on the fixed-rate investment portfolio and on the receive leg of the cross-currency swap.

Those facts and circumstances are evaluated using the steps in Section 2.3.4.

- Step 1: Does the derivative have both of the creator characteristics?
  - Yes. The cross-currency swap has both of the creator characteristics: its underlying is based on observable market rates, and it is senior in priority to other interest holders.
- Step 2: Does the derivative fail the essentially all test?
  - No. Although the swap's notional amount relates to a majority of the legal entity's assets, changes in the cash flows or the fair value of the swap are **not** expected to offset all, or essentially all, the risk or return related to those investments because the cash flows and fair values of the investments are affected by other risk factors (that is, credit risk). Therefore, the derivative creates variability and is not a variable interest.

2.3.4.3 Call Option on Assets

FASB REFERENCES

ASC 810-10-55-25 through 55-26

A call option on an asset is the right (but not the obligation) to buy that asset from another party at a specified exercise price, which may be exercisable at a specific date, during a specific period, or upon a specified event. The exercise price might be a fixed price, at fair value, or written as a formula, which may or may not be intended to approximate fair value (for example, a multiple of revenue or earnings before interest, taxes, depreciation and amortization (EBITDA)).

A call option with a fair value exercise price does not absorb or create variability because it simply replaces one asset (the asset subject to the call option) with an equal amount of cash. However, if the exercise price is a fixed price or a formula, the reporting entity must analyze whether the call option is a variable interest, as shown below.

Counterparty can buy an asset from the legal entity at other than fair value → The call option absorbs variability. The reporting entity next determines whether the call option is an interest in specified assets of the legal entity or a variable interest in that entity as a whole (see Section 2.4) using the steps in Sections 2.3.4.

Legal entity can buy an asset from the counterparty at other than fair value → The call option creates variability in the legal entity because it exposes the legal entity to variability when it replaces cash with that asset. Assets generally create variability in a legal entity (see Section 2.1). Therefore, the call option is **not** a variable interest in the legal entity (however, the legal entity may need to assess whether it has a variable interest in the counterparty).

"FAIR VALUE" IS NOT ALWAYS FAIR VALUE

A reporting entity may negotiate an exercise price intended to approximate fair value. The exercise price might be expressed as a formula and might even be referred to or defined as "fair value" in the agreement. However, such a formula is considered other than fair value because the value of the underlying might change over time compared to the stated formula.

2.3.4.4 Put Option on Assets

FASB REFERENCES

ASC 810-10-55-25 through 55-26

A put option on an asset is the right (but not the obligation) to sell that asset to another party at a specified exercise price, which may be exercisable at a specific date, during a specific period, or upon a specified event. The exercise price might be a fixed price, at fair value, or written as a formula, which may or may not be intended to approximate fair value (for example, a multiple of revenue or EBITDA). Put options may protect a party from suffering losses if that party can put an asset to another party and receive consideration in return.

A put option with an exercise price at fair value does not absorb or create variability because it simply replaces one asset (the asset subject to the put option) with an equal amount of cash. However, if the exercise price is a fixed price or a formula, the reporting entity next analyzes whether the put option is a variable interest, as shown below.

Legal entity can sell assets to the counterparty at other than fair value	→	The put option absorbs variability. The reporting entity next determines whether the put option is an interest in specified assets of the legal entity or a variable interest in that entity as a whole (see Section 2.4) using the steps in Section 2.3.4.
Counterparty can sell assets to the legal entity at other than fair value	→	The put option creates variability in the legal entity because it exposes the legal entity to variability when it replaces cash with that asset. Therefore, the put option is **not** a variable interest in the legal entity (however, the legal entity may need to assess whether it has a variable interest in the counterparty).

"FAIR VALUE" IS NOT ALWAYS FAIR VALUE

A reporting entity may negotiate an exercise price intended to approximate fair value. The exercise price might be expressed as a formula and might even be referred to or defined as "fair value" in the agreement. However, such a formula is considered other than fair value because the value of the underlying might change over time compared to the stated formula.

2.3.4.5 Forward Contracts on Assets

FASB REFERENCES

ASC 810-10-55-27 through 55-28

A forward contract on an asset is the promise to buy (or sell) that asset from (or to) another party at a specified price, and at a specific date or upon a specified event. The price might be a fixed price, at fair value, or written as a formula, which may or may not be intended to approximate fair value (for example, a multiple of revenue or EBITDA).

A forward contract with an exercise price at fair value does not absorb or create variability because it simply replaces one asset (cash) with an equal amount of assets (or vice versa). However, if the exercise price is a fixed price or a formula, the reporting entity must analyze whether the forward contract is a variable interest, as shown below.

Legal entity must sell an asset it currently owns to the counterparty at other than fair value	The forward contract absorbs variability. The reporting entity next determines whether the forward is an interest in specified assets of the legal entity or a variable interest in that entity as a whole (see Section 2.4) using the steps in Section 2.3.4.
Legal entity must sell an asset it does not currently own to the counterparty at other than fair value	The forward contract generally creates variability in the legal entity because it exposes the legal entity to risks that increase the legal entity's expected variability. Therefore, most forward contracts to sell assets not owned by the legal entity are **not** variable interests.
Legal entity must buy assets from the counterparty at other than fair value	The forward contract creates variability in the legal entity because it exposes the legal entity to risks when it replaces cash with the asset subject to the forward contract. Therefore, the forward contract is **not** a variable interest in the legal entity (however, the legal entity may need to assess whether it has a variable interest in the counterparty).

"FAIR VALUE" IS NOT ALWAYS FAIR VALUE

A reporting entity may negotiate an exercise price intended to approximate fair value. The exercise price might be expressed as a formula and might even be referred to or defined as "fair value" in the agreement. However, such a formula is considered other than fair value because the value of the underlying might change over time compared to the stated formula.

Cancellation terms in a forward contract can also affect whether the reporting entity is exposed to the legal entity's variability:

- If the contract is cancellable or conditional (for example, upon obtaining consent from a lender, regulator, or third party or upon the asset's condition), that might indicate the reporting entity is not yet exposed to the asset's variability and therefore does not have a variable interest in the legal entity.

- If the contract is not cancellable and is unconditional, the reporting entity might be exposed to (absorb) the asset's variability, so it must determine whether the forward is an interest in specified assets of the legal entity or a variable interest in that entity as a whole (see Section 2.4) using the steps in Section 2.3.4.

If the reporting entity pays a deposit or up-front payment in a forward contract, that must also be evaluated as a potential variable interest because the buyer (reporting entity) may be exposed to changes in the asset's fair value and the credit risk of the seller legal entity.

See Section 2.3.5 for the extension of these concepts to purchase or supply arrangements.

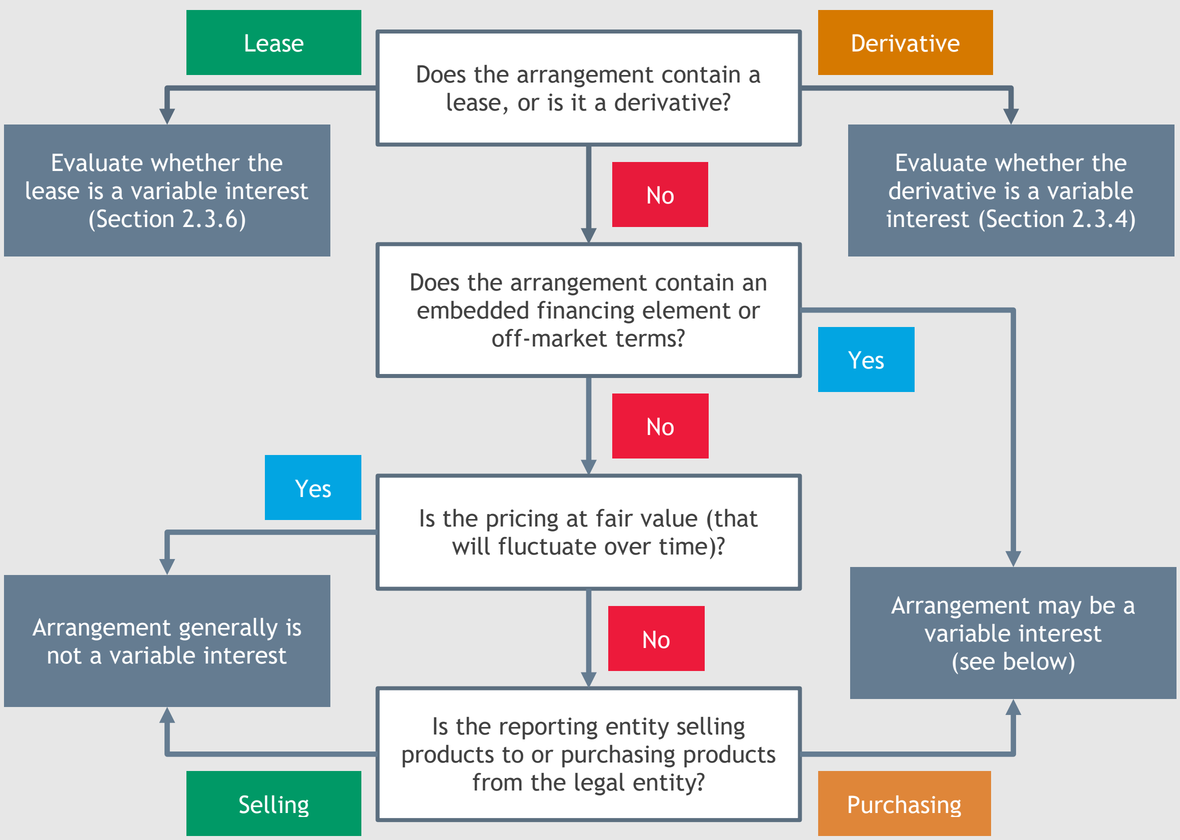
2.3.5 Purchase or Supply Arrangements

ASC 810 does not specifically address how to evaluate whether a purchase or supply arrangement is a variable interest in a legal entity.

BDO INSIGHTS — EVALUATING PURCHASE OR SUPPLY ARRANGEMENTS

To determine whether a purchase or supply arrangement is a variable interest, a reporting entity evaluates the facts and circumstances, including the legal entity's purpose and design, the terms and conditions of the arrangement, including pricing, proportion of products bought or sold, and whether the arrangement contains an embedded financing element that is subordinated financial support.

Reaching a conclusion about whether a purchase or supply arrangement is a variable interest requires the application of professional judgment based on the facts and circumstances. A reporting entity can use the decision tree and table below to evaluate whether a purchase or supply arrangement is a variable interest.



<table>
<tr><th>TERMS</th><th>CONSIDERATIONS</th></tr>
<tr><td>A reporting entity commits to purchasing from or selling products to a legal entity in an arrangement that includes an embedded financing element or off-market terms.</td><td>An embedded financing element or off-market prices in a purchase or supply arrangement may indicate a reporting entity is providing financial or other subordinated financial support to the legal entity or may reallocate the legal entity’s expected variability among its interest holders. Therefore, a purchase or supply arrangement with an embedded financing element or off-market pricing generally is a variable interest.</td></tr>
<tr><td>A reporting entity commits to purchasing the legal entity’s products or selling products to the legal entity at fair value at the exchange date.</td><td>When the pricing is at fair value and is set at the exchange date (not the commitment date), the arrangement does not absorb or create variability because it simply replaces one asset (the fair value of the inventory) with an equal amount of cash (or vice versa). Therefore, the purchase or supply arrangement is not a variable interest.</td></tr>
<tr><td>A reporting entity commits to purchasing products from the legal entity in the future at either:
A fixed price
A formula (for example, cost plus a margin)</td><td>The arrangement may absorb variability from the legal entity depending on its purpose and design. The higher the volume of products compared to the legal entity’s size, the more likely the arrangement is designed for the reporting entity to absorb the legal entity’s variability and therefore may be a variable interest in that entity as a whole.
The reporting entity evaluates whether it has an interest in specified assets of the legal entity or a variable interest in that entity as a whole (see Section 2.4).
The arrangement may also create an implicit variable interest in which the reporting entity supports the legal entity (see Section 2.6).</td></tr>
<tr><td>A reporting entity commits to selling products to the legal entity in the future at either:
A fixed price
A formula (for example, cost plus a margin)</td><td>The arrangement creates variability in the legal entity because it exposes the legal entity to risks when it replaces one asset (cash) with the purchased asset.</td></tr>
</table>

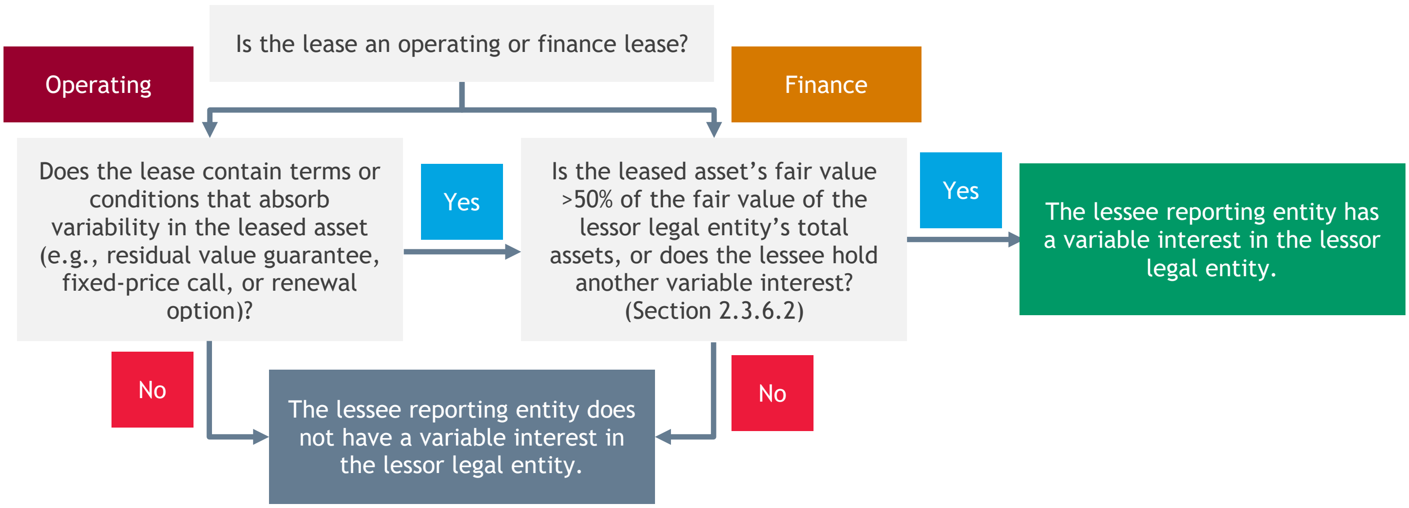
2.3.6 Leases

FASB REFERENCES

ASC 810-10-25-31 and ASC 810-10-55-39

ASC 810 includes specific guidance for lessees. The flowchart below illustrates how a lessee reporting entity can determine whether it has a variable interest in a lessor legal entity. See our Blueprint, Accounting for Leases Under ASC 842, for guidance on evaluating lease classification.

However, the role of the contract or arrangement in the legal entity’s design dictates whether the lease creates or absorbs variability regardless of its legal form or accounting classification. Depending on its terms and conditions, a lease may be a variable interest in a legal entity. A reporting entity considers the legal entity’s purpose and design (see Section 2.2.2.2) when determining whether a lease is a variable interest. A lessee reporting entity must also identify any silos in the lessor legal entity (see Section 2.5) and consider whether it has an implicit variable interest in the lessor legal entity (see Section 2.6).



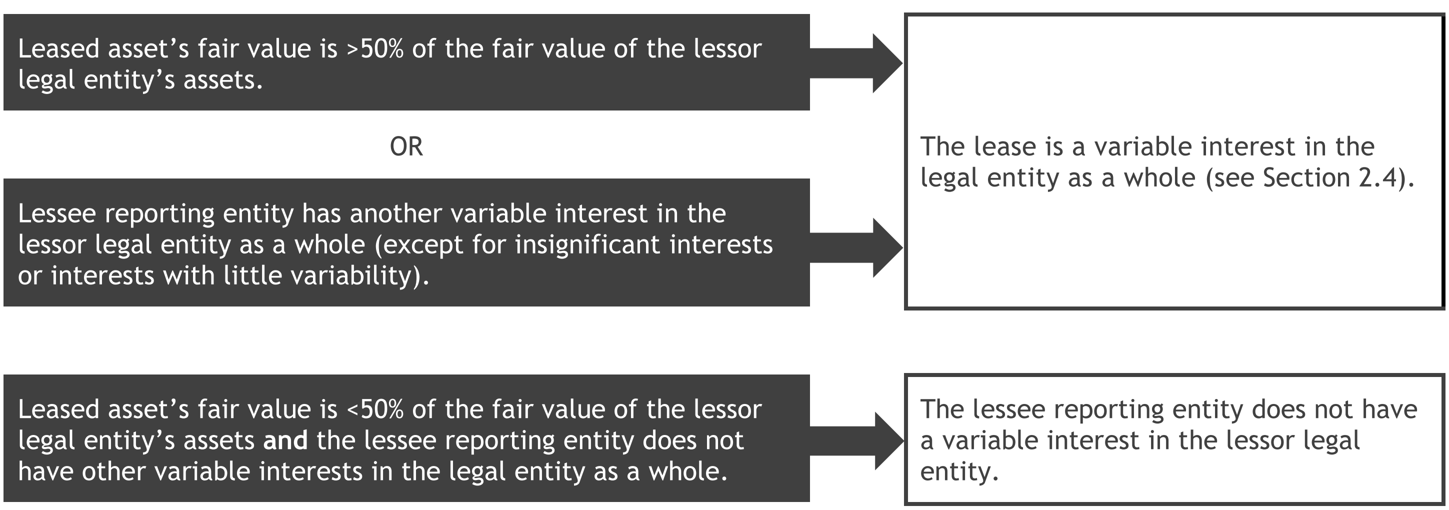
2.3.6.1 Operating Leases

FASB REFERENCES

ASC 810-10-55-39, ASC 810-10-55-78 through 55-80, and ASC 810-10-55-172 through 177

A lessee reporting entity may absorb variability in the lessor legal entity through an operating lease if the lease includes off-market terms, residual value guarantees, fixed-price purchase options, or similar features. When the operating lease does not include such terms or conditions, it generally **creates** variability for the lessor legal entity; therefore, the lessee reporting entity does **not** have a variable interest in the lessor legal entity.

When a lease arrangement includes off-market terms, residual value guarantees, fixed-price purchase options, or similar features, the lease may be a variable interest in the lessor legal entity if it absorbs variability the legal entity was designed to create and pass along to its interest holders. If it does, the reporting entity determines whether the lease is an interest in specified assets of the legal entity or a variable interest in that entity as a whole, as shown below. A lessee reporting entity also must identify any silos in the legal entity (see Section 2.5).

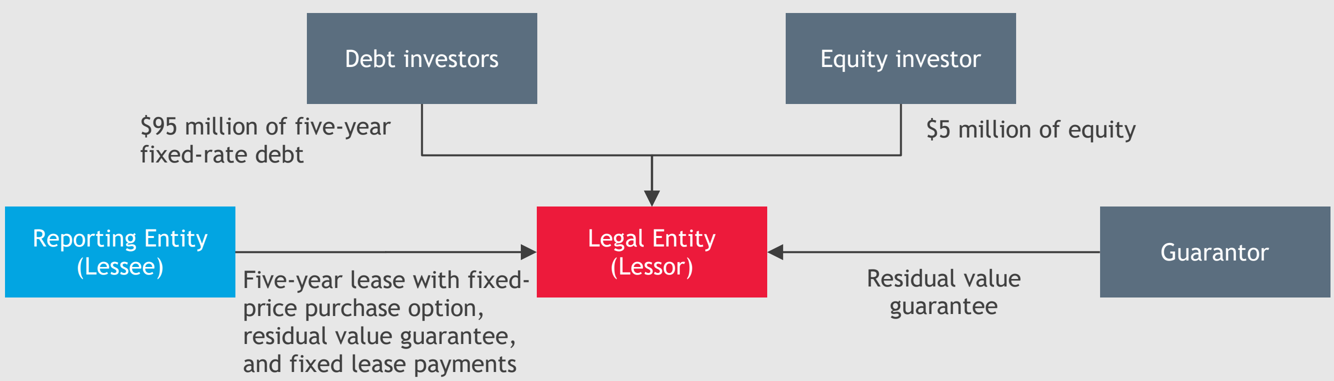


Example 2-7 illustrates the evaluation of a lease that includes a residual value guarantee and a fixed-price purchase option.

EXAMPLE 2-7 (ADAPTED FROM ASC 810-10-55-78 THROUGH 55-80 AND ASC 810-10-55-172 THROUGH 55-177): OPERATING LEASE WITH RESIDUAL VALUE GUARANTEE AND FIXED-PRICE PURCHASE OPTION

FACTS

- A legal entity was formed and financed with $95 million of fixed-rate debt that matures in five years and $5 million of equity. It used the proceeds to buy a property, which it leased to a lessee with an AA credit rating.
- The lease has a five-year term and cannot be unilaterally terminated by either party.
- The lessee guaranteed the property's residual value at the end of five years and has a fixed-price purchase option on the property for the same amount (the option price). If the lessee does not exercise the option at the end of the lease term, it must resell the property on the lessor legal entity's behalf.
  - If the property sells for less than the option price, the lessee must pay the lessor legal entity the difference between the option price and the sales proceeds, up to a specified percentage of the option price.
  - If the property sells for more than the option price, the lessee keeps any excess.
- A third party provided a small additional residual value guarantee to the lessor legal entity.
- The lessor legal entity cannot buy other assets or sell the property for five years. It was designed so the lessee has the right to use the property through an operating lease and to keep substantially all the risks and rewards from changes in the property value.
- The debt was marketed to potential debt investors as a fixed-rate investment in an AA-rated asset collateralized by the property.
- The lease is classified as a direct financing lease by the lessor legal entity and as an operating lease by the lessee.



CONCLUSION

The lessee has a variable interest in the lessor legal entity because of the residual value guarantee and the fixed-price purchase option. The guarantor also has a variable interest in the lessor legal entity from its residual value guarantee. The debt and equity are also variable interests. See Example 3-20 for the determination of whether the lessor legal entity is a VIE. See Example 4-26 for the identification of its primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - Price risk on changes in the property's fair value.
  - Credit risk from a potential default by the lessee on lease payments.
  - Interest rate risk from changes in the fair value of the future lease payments.

- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The legal entity's purpose and design is to provide the lessee with use of the property for five years and pass along substantially all the rights and obligations of ownership, including tax benefits, to the lessee.
  - The debt was marketed to potential debt investors as a fixed-rate investment in an AA-rated asset collateralized by the property.
  - Although the lease payments are fixed, the legal entity was not designed to pass along interest rate risk from interim changes in the fair value of the lease payments because the legal entity cannot sell the property before its fixed-rate debt matures.
  - The residual value guarantee exposes the lessee to substantially all the risks of decreases in the property value. The lessee absorbs variability from changes in the property's fair value, which is a strong indicator of variability the lessor legal entity was designed to create and pass along to its interest holders. Therefore, the residual value guarantee is a variable interest.
  - The fixed-price purchase option transfers substantially all the rewards from increases in the property value to the lessee. The lessee absorbs variability from changes in the property's fair value, which is a strong indicator of variability the lessor legal entity was designed to create and pass along to its interest holders. Therefore, the fixed-price purchase option is a variable interest.
  - The lease terms, including the residual value guarantee and purchase option, are considered in the analysis regardless of the lease's legal form or accounting classification. The lessor legal entity is exposed to price risk for changes in the property's fair value, even though it recognizes a net investment in the lease (not the underlying property).
  - The debt and equity absorb the legal entity's variability and therefore are variable interests.

2.3.6.2 Finance Leases

ASC 810 does not specifically address whether a finance lease is a variable interest.

BDO INSIGHTS — FINANCE LEASES MAY BE VARIABLE INTERESTS

We believe a finance lease generally is an interest in specified assets because it absorbs the variability of the leased asset. Accordingly, we believe a lessee reporting entity should evaluate whether a finance lease is a variable interest in the lessor legal entity as a whole.

An interest in specified assets of a legal entity is a variable interest in that entity as a whole if **either** of two conditions is met (see Section 2.4):

- The fair value of the specified assets is more than half the fair value of the lessor legal entity's total assets.
- The lessee reporting entity has another variable interest in the lessor legal entity as a whole (except for insignificant interests or interests with little variability).

A lessee reporting entity must also determine whether the lease results in a silo or an implicit variable interest in the lessor legal entity (see Sections 2.5 and 2.6, respectively).

2.3.6.3 Sale and Leaseback Transactions

FASB REFERENCES

ASC 606-10-32-2 through 32-27, ASC 810-10-25-31, ASC 810-10-25-55, and ASC 842-40-25

In a sale and leaseback transaction, one entity (the seller-lessee) transfers an asset it owns to another entity (the buyer-lessor legal entity) and leases that asset back from that other entity.

For transactions in the scope of the sale and leaseback guidance in ASC 842, the seller-lessee and the buyer-lessor apply the guidance in ASC 842-40-25 to determine whether to account for the transaction as a sale and leaseback or as a financing arrangement. The following table describes the accounting.

	SELLER-LESSEE	BUYER-LESSOR
Sale and leaseback at market terms	▶ Derecognizes the underlying asset's carrying amount ▶ Recognizes the transaction price in accordance with ASC 606, *Revenue From Contracts with Customers* ▶ Recognizes a gain or loss for the difference between the transaction price and the asset's carrying amount ▶ Accounts for the leaseback in accordance with ASC 842-20, *Leases — Lessee*	▶ Recognizes the underlying asset in accordance with other U.S. GAAP (generally ASC 360, *Property, Plant and Equipment*) ▶ Accounts for the leaseback in accordance with ASC 842-30, *Leases — Lessor*
Financing arrangement (not a sale and leaseback)	▶ Continues to recognize the transferred asset and applies ASC 360 (for example, depreciation, impairment) ▶ Recognizes amounts received as a financial liability in accordance with other U.S. GAAP ▶ Allocates rent payments between interest expense and principal amortization	▶ Does not recognize the transferred asset ▶ Recognizes amounts paid as a receivable in accordance with other U.S. GAAP ▶ Allocates rent received between interest income and principal amortization

However, a seller-lessee must determine whether it has a variable interest in the buyer-lessor legal entity regardless of the transaction's legal form or accounting classification. For example, the seller-lessee could have an interest in specified assets if the leaseback is a finance lease (see Section 2.3.6.2) or if the leaseback includes a fixed-price repurchase option, residual value guarantee, or another feature that absorbs the leased asset's variability (see Section 2.3.6.1). In those cases, the seller-lessee must determine whether it has a variable interest in the buyer-lessor legal entity as a whole (see Section 2.4).

When determining whether the lease is a variable interest, the reporting entity considers the nature of the risks in the lessor legal entity and the variability it was designed to create and pass along to its interest holders regardless of the accounting for the sale and leaseback. For example, the buyer-lessor legal entity may be exposed to price risk in changes in the fair value of the underlying asset, even if it recognizes a financing receivable, not the underlying asset, in a failed sale-leaseback.

Because sale and leaseback transactions are structured in many ways, reaching a conclusion about whether a sale and leaseback arrangement is a variable interest in the buyer-lessor legal entity requires the application of professional judgment based on the facts and circumstances.

See Section 7.2 of our Blueprint, [Accounting for Leases Under ASC 842](), for guidance on sale and leaseback transactions.

2.3.7 Licenses and Royalty Arrangements

Licenses and royalty arrangements are used to obtain (or transfer) rights and economic benefits related to intellectual property (for example, trademarks and proprietary technologies). The licensee may pay the licensor a fixed amount or an amount based on revenue or other performance indicators or metrics. For example:

- The owner of a trademark or technology may license the right to manufacture and sell products using the proprietary trademark or technology to a licensee in exchange for a royalty, such as a stated percentage of the product revenues.
- A pharmaceutical company may license its intellectual property and collect fees based on the licensee's gross profit margin from biomedical product sales.

BDO INSIGHTS — DETERMINING WHETHER A LICENSE OR ROYALTY ARRANGEMENT IS A VARIABLE INTEREST

ASC 810 does not specifically address how to evaluate whether a license or royalty arrangement is a variable interest in a legal entity. A reporting entity (licensor) may have a variable interest in the licensee legal entity if the license absorbs changes in the fair value of the legal entity's net assets (for example, through license payments from revenue generated using the intangible asset or other item subject to the license or royalty). The reporting entity must consider the terms and conditions of the license arrangement, the purpose for which the licensee legal entity was created, and the variability the licensee legal entity is designed to create and pass along to its interest holders. The reporting entity may also need to evaluate whether that license is an interest in specified assets of the licensee legal entity or a variable interest in that entity as a whole (see Section 2.4). All facts and circumstances must be evaluated before concluding whether a license or royalty arrangement is a variable interest.

2.3.8 Fees Paid to a Decision Maker or Service Provider

FASB REFERENCES

ASC 810-10-20: Decision Maker, ASC 810-10-55-37 through 55-38, and ASC 810-10-55-205L through 55-205Y

Fees paid to a decision maker or service provider may be variable interests. ASC 810 defines a decision maker as "*an entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity's economic performance.*"

Fees paid to a decision maker or service provider are **not** variable interests if **all** the following conditions are met:

- The service arrangement includes only terms, conditions, and amounts **customarily** present in arrangements for similar services negotiated at arm's length (see Section 2.3.8.1).
- The fees are compensation for services provided and **commensurate** with the level of effort to provide those services (see Section 2.3.8.1).
- The decision maker or service provider does not hold other interests in the legal entity that **would** absorb more than an insignificant amount of the legal entity's expected variability (see Section 2.3.8.2).
- The decision maker or service provider is not exposed to risk of loss (see Section 2.3.8.3).

Customary + Commensurate + No other interests + No risk of loss = Fees are **not** variable interests

Fees paid to a decision maker or service provider that do not meet all the conditions above are variable interests. However, when fees are not variable interests, the decision maker or service provider functions as an agent or fiduciary of the variable interest holders and cannot be the legal entity's primary beneficiary.

TERMS STATING THAT A REPORTING ENTITY IS AN AGENT OR A FIDUCIARY ARE NOT DETERMINATIVE

Agreements, laws, and regulations sometimes state that one entity is acting as an agent or as a fiduciary. When determining whether fees are variable interests, such statements are not relevant to the analysis; the reporting entity must determine whether the fees are variable interests solely using the conditions in ASC 810.

The SEC staff said a decision maker that does not have a variable interest in the legal entity would not be identified as the legal entity's primary beneficiary.

SEC STAFF GUIDANCE

Remarks Before the 2015 AICPA National Conference on Current SEC and PCAOB Developments

Christopher D. Semesky, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *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 my example, if the manager determines that its fee is not a variable interest [the guidance in ASC 810 is] 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.* [Footnotes omitted.]

Examples 2-8 and 2-9 illustrate whether fees paid to a decision maker or service provider are variable interests.

EXAMPLE 2-8 (ADAPTED FROM ASC 810-10-55-205L THROUGH 55-205V): INVESMENT FUND WITH DECISION-MAKER FEES and Additional Interests

FACTS

- A fund manager (the general partner) formed an investment fund (a limited partnership) and sold partnership interests to investors (limited partners).
- The general partner marketed the partnership interests to the limited partners as an opportunity to earn returns by investing in a fund in which the general partner decides how to invest the fund's assets within the parameters and objectives in the limited partnership agreement.
- The general partner receives fees that are customary and commensurate, and it is not exposed to risk of loss.
- However, the general partner's equity ownership interest in the fund **would** absorb more than an insignificant amount of the fund's expected variability.

CONCLUSION

The general partner's fees are variable interests. See Example 3-26 for the determination of whether the fund is a VIE and Example 4-10 for the identification of its primary beneficiary.

ANALYSIS

- When determining whether it has a variable interest, the general partner evaluates whether its direct and indirect interests in the fund would absorb more than an insignificant amount of the fund's expected variability and concludes they would. Therefore, the fees do not meet all the conditions and are variable interests.

EXAMPLE 2-9 (ADAPTED FROM ASC 810-10-55-205W THROUGH 205Y): INVESTMENT FUND WITH DECISION-MAKER FEES AND NO ADDITIONAL INTERESTS

FACTS

- Assume the same facts as in Example 2-8, except that the general partner does not hold direct or indirect interests in the fund that would absorb more than an insignificant amount of the fund's expected variability.
- However, several of the general partner's employees have interests in the fund, which they financed themselves.

CONCLUSION

The general partner's fees are not variable interests. The general partner stops its consolidation analysis.

ANALYSIS

- When determining whether it has a variable interest, the general partner evaluates whether its direct and indirect interests in the fund would absorb more than an insignificant amount of the fund's expected variability. In this evaluation, the general partner does not include its employees' interests in the fund because it did not finance those interests (see Section 2.3.8.2.1). Therefore, it has neither a direct nor an indirect interest in the fund that would absorb more than an insignificant amount of the fund's expected variability.
- The fees paid to the general partner also are customary and commensurate, and the general partner does not have other interests in the fund or risk of loss. Therefore, the fees meet all the conditions and are not variable interests.

2.3.8.1 Customary and Commensurate

FASB REFERENCES

ASC 810-10-55-37(a), ASC 810-10-55-37(d), and ASC 810-10-55-37B

Customary + Commensurate + No other interests + No risk of loss = Fees are **not** variable interests

A reporting entity must determine whether fees paid to a decision maker or service provider are customary and commensurate to assess whether the fees are variable interests. That determination also is relevant when identifying the primary beneficiary of a VIE because fees that are customary and commensurate and do not expose the decision maker to risk of loss are excluded when evaluating whether a party has economics (see Section 4.3.3).

Evaluating whether fees are customary and commensurate requires the application of professional judgment based on the facts and circumstances. When assessing whether fees are customary and commensurate, the factors in the following table may be relevant to consider.

FACTOR	CONSIDERATIONS
Arm's-length negotiations	Arrangements negotiated at arm's length between unrelated parties are more likely to be customary and commensurate.
Standard industry terms	Arrangements with standard industry terms (including the amounts and nature of variability, form and timing of payment, and claw back provisions) are more likely to be customary and commensurate. Benchmarking is not explicitly required by ASC 810, but it might be helpful.
Magnitude	In isolation, the magnitude of the fees does not cause the fees to be variable interests; all facts and circumstances are considered.
Unique terms	Arrangements with unique terms do not automatically fail the customary and commensurate condition. Instead, a decision maker or service provider evaluates the arrangement's purpose and design and the facts and circumstances (for example, whether services were priced at cost plus a reasonable profit margin and whether fees were appropriately adjusted for any new services).
Fee waivers	Arrangements in which fees are waived for a period of time could still be customary and commensurate, depending on the facts and circumstances, including whether: ▶ Fee waivers are common in the industry. ▶ The reporting entity has a policy for waiving fees. ▶ The fee arrangement (inclusive of the waiver) is similar to other arrangements and commensurate with the services provided.

The SEC staff discussed its views on evaluating whether fees are customary and commensurate.

SEC STAFF GUIDANCE

Remarks Before the 2015 AICPA National Conference on Current SEC and PCAOB Developments

Christopher D. Semesky, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *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.* [Footnotes omitted.]

BDO INSIGHTS — CLEAN-UP CALLS IN SECURITIZATION ARRANGEMENTS

Securitization arrangements often provide the servicer with a clean-up call right, which allows the servicer to buy the remaining transferred assets or the outstanding beneficial interests near the end of the securitization's term when servicing the remaining assets in the securitization vehicle becomes burdensome.

We believe clean-up calls often are customary in asset-backed securitization arrangements. In our experience, a clean-up call also generally does **not** create an other interest or expose the servicer to risk of loss (see Sections 2.3.8.2 and 2.3.8.3, respectively).

However, a servicer that holds a call option to buy assets or outstanding beneficial interests with terms and conditions that differ from a customary clean-up call (for example, a call option exercisable throughout the securitization's term) may absorb variability the legal entity was designed to create and pass along to its interest holders. See Section 2.3.4.3 for guidance on call options on assets and Section 2.3.1.2 for call options on the legal entity's equity (or beneficial interests). Such options may be other interests (see Section 2.3.8.2) that cause a servicer's fees to be variable interests.

Determining whether a clean-up call is an other interest or is not customary, which both can cause fees to be variable interests, requires the application of professional judgment based on the facts and circumstances, including the legal entity's purpose and design and the variability it was designed to create and pass along to its interest holders.

2.3.8.2 Other Interests

FASB REFERENCES

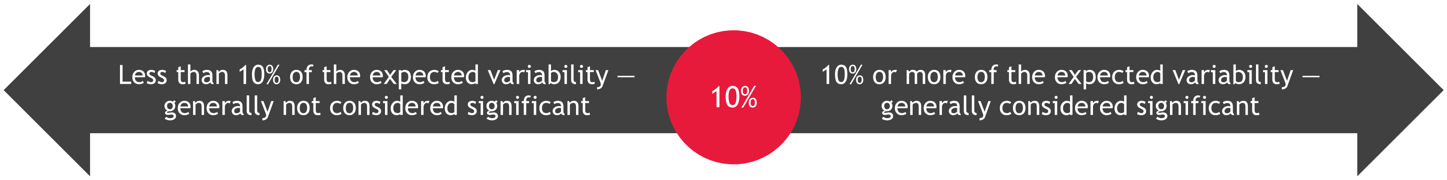
ASC 810-10-55-37(c), ASC 810-10-55-37D, and ASC 810-10-55-96 through 55-109

Customary + Commensurate + No other interests + No risk of loss = Fees are **not** variable interests

When evaluating whether fees are variable interests, a decision maker or service provider evaluates its other interests in the legal entity. Other interests include direct or implicit interests the decision maker holds in the legal entity, and indirect interests held through a related party or de facto agent. If the decision maker or service provider does not hold other interests in the legal entity that individually or in the aggregate **would** absorb more than an insignificant amount of the legal entity's expected variability, **and** the fees meet the other conditions, the fees paid to the decision maker or service provider are **not** variable interests.

The phrase "more than insignificant" is not defined in ASC 810, but it generally means "significant." This evaluation focuses on scenarios that **would** be expected and the legal entity's expected **variability** (which often differs from net income).

There are no bright lines; however, practice has generally considered significance as shown in the following graphic:



However, the evaluation is not solely quantitative. A decision maker or service provider qualitatively evaluates whether its fees are variable interests. Factors to consider in this evaluation include:

- Legal entity's purpose and design
- Nature and terms of the other interests held in the legal entity
- Seniority of the other interests held
- Size of the other interests compared to the legal entity's capitalization
- Magnitude of the **variability** absorbed by the decision maker's other interests compared to other variable interests

A QUALITATIVE APPROACH GENERALLY SUFFICES WHEN EVALUTING OTHER INTERESTS

Quantitatively determining whether decision maker or service provider fees would absorb more than an insignificant amount of the legal entity's expected variability may be complex when the legal entity has multiple classes of subordinated interests (such as debt or equity) with variability in seniority and cash flows.

However, using the quantitative approach described in the definitions of expected losses, expected residual returns, and expected variability is **not** required and is not the sole determinant of whether an other interest causes fees to be variable interests. A decision maker or service provider generally can qualitatively make this determination. Evaluating whether an other interest causes fees to be variable interests requires the application of professional judgment based on the facts and circumstances.

The requirement in ASC 810-10-55-37(c) to evaluate whether other interests "*would absorb more than an insignificant amount*" of the VIE's expected variability when evaluating whether fees are variable interests differs from the criterion in ASC 810-10-25-38A(b) used when identifying the primary beneficiary of a VIE (see Section 4.3), which requires a reporting entity to determine whether it has economics that "*could potentially be significant to the VIE.*"

- The word "would" implies that a reporting entity considers the **probability** of expected outcomes over the legal entity's life when identifying variable interests.
- Conversely, the word "could" implies that a reporting entity considers all **possible** or **potential** outcomes when identifying the primary beneficiary of a VIE.

In other words, "*would absorb more than an insignificant amount*" of the VIE's expected variability is a higher threshold. Therefore, a decision maker or service provider that meets the "would" threshold for identifying a variable interest also generally meets the "could" threshold when identifying the primary beneficiary.

BDO INSIGHTS — EQUITY-SETTLED CARRIED INTERESTS

In some industries (such as asset management and private equity) a general partner receives carried interest, fees that compensate the general partner based on the legal entity's performance, so the general partner receives disproportionately more of the legal entity's returns after the limited partners receive a stated return. For example, a general partner may receive 20% of the legal entity's returns after the limited partners receive a 10% return on their investments. Terms and structures vary: the carried interest may be stated in the fee arrangement or embedded in the general partner's equity.

In many cases, the general partner receives these performance-based returns in cash or as an increase to its capital account. In practice, we have observed that general partners treat these performance-based returns **either**:

- As part of their decision maker or service provider fee, **not** as an other interest
- Separate from their decision maker or service provider fee, as an other interest

- A general partner must consistently apply its selected accounting policy when evaluating control of legal entities in accordance with ASC 810. See also Section 1.2.1 of our Blueprint, Revenue Recognition Under ASC 606, for considerations related to the accounting for carried interests in accordance with ASC 606.

In some cases, new equity is issued to settle the carried interests. We believe any new equity issued increases the general partner's other interests absent facts and circumstances indicating otherwise (for example, a right to claw back the newly issued equity if the legal entity's performance worsens). If the general partner initially determines that its fees are not variable interests and later determines the equity issued to settle the carried interest is an other interest, the general partner must reevaluate whether its fees are variable interests (see Section 2.3.8.4). The new equity issued to the general partner may result in the partner absorbing more than an insignificant amount of the partnership's variability. If so, the fees would become variable interests and would require further assessment. Determining whether an equity-settled carried interest causes the fees to be variable interests requires the application of professional judgment based on the facts and circumstances.

BDO INSIGHTS — SEED CAPITAL

When a decision maker or service provider invests seed capital in a start-up company or fund in exchange for equity it must determine whether the seed capital absorbs more than an insignificant amount of the legal entity's expected variability. Depending on the size of the seed capital investment compared to other investors' interests at the time, the seed capital may be a significant percentage of the equity; if so, the fees are variable interests. Whether the decision maker's seed capital might be diluted in the future is irrelevant for the initial analysis; dilution is considered when it occurs. Determining whether seed capital absorbs more than an insignificant amount of variability requires the application of professional judgment based on the facts and circumstances.

Examples 2-10 and 2-11 illustrate the analysis of other interests when evaluating whether fees paid to a decision maker or service provider are variable interests.

EXAMPLE 2-10 (ADAPTED FROM ASC 810-10-55-96 THROUGH 55-109): COMMERCIAL MORTGAGE-BACKED SECURITIZATION

FACTS

- A legal entity was formed and financed with $94 million of investment-grade fixed-rate bonds (issued in three tranches to third-party investors) that mature in seven years and $6 million of equity held by the special servicer.
- It used the proceeds to buy from a transferor $100 million of BB-rated fixed-rate commercial mortgage loans maturing in seven years. If the loans are extinguished before maturity, the borrowers must pay the full scheduled interest and principal.
- Interest and principal received are paid to the bondholders in order of seniority. Therefore, any shortfall is absorbed by the equity and the most subordinate bond class(es) in reverse order of priority.
- The transaction was marketed to potential bondholders as an investment in a portfolio of commercial mortgage loans with exposure to credit risk from potential loan defaults.
- The equity absorbs the first-dollar loss and receives any residual returns.
- The primary servicer (which also is the transferor) and special servicer (equity holder) receive decision-maker fees that are customary and commensurate (see Section 2.3.8.1) and that do not explicitly expose the servicers to risk of loss.

CONCLUSION

The fees paid to the special servicer are variable interests. The fees paid to the primary servicer are not variable interests unless the primary servicer has an implicit variable interest that would absorb a more than insignificant amount of the legal entity's expected losses. See Example 4-20 for the identification of the primary beneficiary.

ANALYSIS

- The special servicer holds 100% of the equity. Therefore, it has an other interest that would absorb a more than insignificant amount of the legal entity's expected variability. Even though the fees are customary and commensurate, the other interests held by the special servicer cause its fees to be variable interests.
- The primary servicer does not hold equity or other explicit variable interests in the legal entity. It must evaluate whether it has an implicit variable interests (for example, those that may arise from its reputational risk, see Section 2.6) and, if so, whether it would absorb a more than insignificant amount of the legal entity's expected losses. If not, because the fees are customary and commensurate, and the primary servicer does not have other interests or risk of loss, the fees are not variable interests.

EXAMPLE 2-11: INVESTMENT FUND WITH DECISION-MAKER FEES AND ADDITIONAL INSIGNIFICANT INTEREST

FACTS

- A fund manager (the general partner) formed an investment fund (a limited partnership) and sold partnership interests to investors (limited partners).
- The general partner marketed the partnership interests to the limited partners as an opportunity to earn returns by investing in a fund in which the general partner decides how to invest the fund's assets within the parameters and objectives in the limited partnership agreement.
- No limited partners are related parties of the general partner.
- The general partner receives fees that are customary and commensurate, and it is not exposed to risk of loss.
- The general partner also holds 1% of the limited partnership interests, which share in risks and rewards proportionate to other limited partnership interests.

CONCLUSION

The general partner's fees are not variable interests, but its 1% equity interest is a variable interest.

ANALYSIS

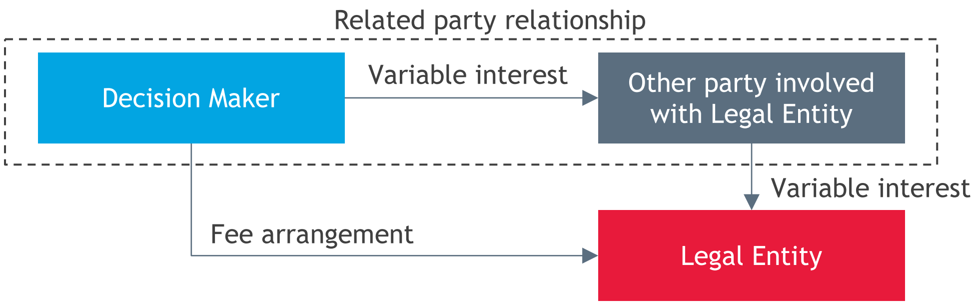
- The general partner's 1% limited partnership interest is a variable interest (see Section 2.3.1).
- However, the 1% limited partnership interest would **not** absorb more than an insignificant amount of the fund's expected variability. Therefore, this other interest does not cause the general partner's fees to be variable interests. The fees are customary and commensurate and do not expose the general partner to risk of loss. Therefore, the fees meet all the conditions and are not variable interests.

2.3.8.2.1 Other Interests Held by Related Parties

FASB REFERENCES

ASC 810-10-55-37D

When evaluating whether fees are variable interests, a decision maker or service provider includes indirect interests held through related parties (including de facto agents, except for interests held by employees or the decision maker or service provider's employee benefit plans unless the employees or employee benefit plans are used to circumvent the VIE model). An indirect interest exists when a reporting entity has a direct variable interest in a related party and the related party has a direct variable interest in the legal entity, as shown.



Such indirect interests generally are considered proportionately. For example, if a decision maker or service provider has a 20% interest in a related party that has a 40% interest in the legal entity, and the interests share returns pro rata, the decision maker or service provider has an 8% indirect interest in the legal entity. The decision maker or service provider aggregates this 8% indirect interest held through its related party with its direct interests to determine whether it absorbs more than an insignificant amount of the legal entity's expected variability.

BDO INSIGHTS — DISPROPORTIONATE INDIRECT INTERESTS

Judgment is needed to determine how much variability a reporting entity absorbs when economics are distributed disproportionately compared to the legal entity's stated ownership percentages. Reaching a conclusion about whether such indirect interests absorb more than an insignificant amount of the legal entity's expected variability requires the application of professional judgment based on the facts and circumstances.

BDO INSIGHTS — INDIRECT INTERESTS HELD THROUGH SUBSIDIARIES

Although ASC 810 indicates that indirect interests are considered on a proportionate basis, we believe this guidance does not apply to indirect interests held through a reporting entity's subsidiaries (legal entities controlled by the reporting entity). Instead, we believe a reporting entity considers indirect interests held through its subsidiaries in their entirety (not proportionately) because the parent and subsidiary are considered a single economic entity. Evaluating indirect interests requires the application of professional judgment based on the facts and circumstances.

The SEC staff said that when an indirect interest is used to separate power and economics to avoid consolidating a legal entity, such separation might be viewed as nonsubstantive.

SEC STAFF GUIDANCE

Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments

Christopher D. Semesky, Professional Accounting Fellow, SEC Office of the Chief Accountant

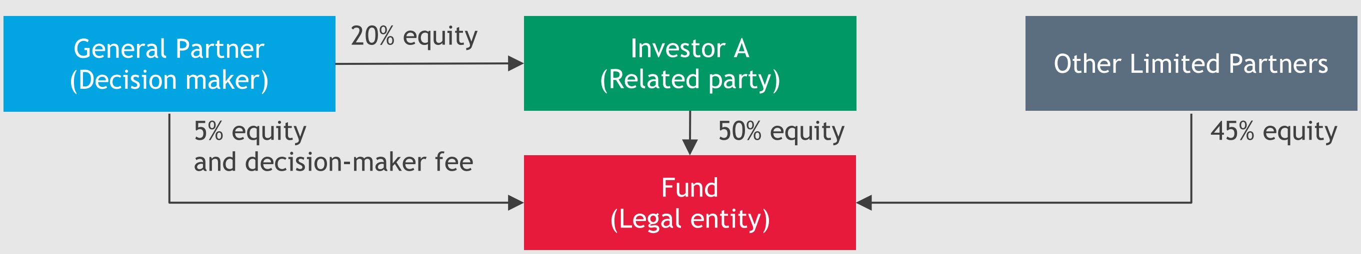
> *For purposes of illustration consider an entity that has four unrelated investors with equal ownership interests, and a manager that is under common control with one of the investors. The manager has no direct or indirect interests in the entity other than through its management fee, and has the power 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. 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, [the SEC Office of the Chief Accountant] has viewed such separation to be non-substantive.* [Footnotes omitted.]

Examples 2-12 through 2-14 illustrate the analysis of indirect interests (through interests held by related parties) when evaluating whether fees paid to a decision maker or service provider are variable interests.

EXAMPLE 2-12: DECISION-MAKER FEES AND INDIRECT INTEREST THROUGH A RELATED PARTY

FACTS

- A fund manager (the general partner) formed a limited partnership and sold partnership interests in an investment fund to investors (limited partners), with ownership percentages as shown. All returns are shared pro rata.



- The general partner marketed the partnership interests to the limited partners as an opportunity to earn returns by investing in a fund in which the general partner decides how to invest the fund's assets within the parameters and objectives in the limited partnership agreement.
- The general partner receives fees that are customary and commensurate, and it is not exposed to risk of loss.
- The general partner also owns 20% of Investor A's equity. The general partner is a related party to Investor A but does not control Investor A (as determined in accordance with ASC 810).

CONCLUSION

The general partner has variable interests related to the fees and its 5% direct and 10% indirect equity interests.

ANALYSIS

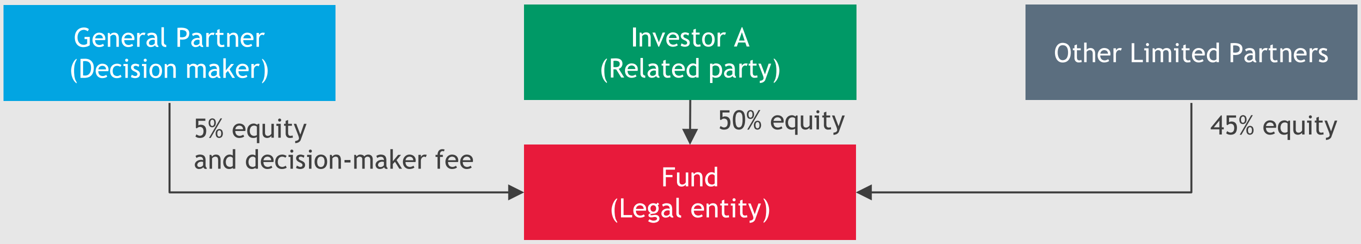
- The general partner has an indirect interest in the fund through Investor A, its related party, of 10% (20% of 50%).
- The general partner has economics of 15% (5% direct interest and 10% indirect interest), an amount generally considered significant, so it has other interests in the fund that would absorb more than an insignificant amount of the fund's expected variability. Therefore, even though the fees are customary and commensurate and do not expose the general partner to risk of loss, the other interests held by the general partner cause the fees to be variable interests.
- The 5% direct equity interest and the 10% indirect interest also are variable interests.

EXAMPLE 2-13: DECISION-MAKER FEES AND NO INDIRECT INTEREST

FACTS

- Assume the same facts as in Example 2-12, except the general partner does not have an interest in Investor A (so it does not have an indirect interest in the fund through Investor A) and the ownership percentages are as shown.

CONCLUSION



The general partner's fees are not variable interests, but its 5% direct equity interest is a variable interest.

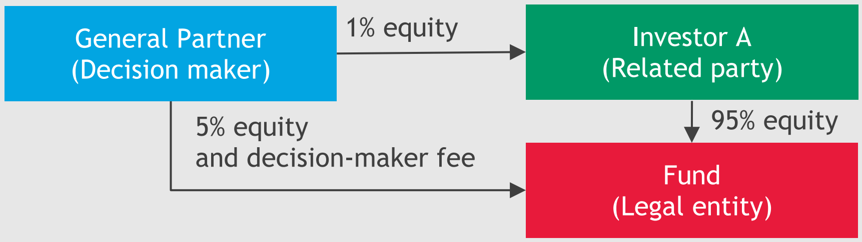
ANALYSIS

- Assuming the general partner does not have an implicit variable interest in Investor A and did not structure the arrangements to avoid consolidating the fund, the general partner does not have an indirect interest in the fund through Investor A, its related party, because it does not have a variable interest in Investor A.
- The general partner has economics of 5%, an amount generally considered insignificant; therefore, it does not have other interests in the fund that would absorb more than an insignificant amount of the fund's expected variability. Because the fees are customary and commensurate and do not expose the general partner to risk of loss, and because the other interests are not significant, the fees are not variable interests.
- However, the general partner's 5% direct equity interest is a variable interest.

EXAMPLE 2-14: DECISION MAKER AND INDIRECT INTEREST

FACTS

- Assume the same facts as in Example 2-12, except with ownership percentages as shown.



CONCLUSION

The general partner's fees are not variable interests, but its 5% direct and approximately 1% indirect equity interests are variable interests.

ANALYSIS

- The general partner has an indirect interest in the fund through Investor A, its related party, of approximately 1% (1% of the 95% equity interest is 0.95%, or approximately 1%).
- The general partner has economics of approximately 6% (its 5% direct interest plus its approximately 1% indirect interest), an amount generally considered insignificant; therefore, it does not have other interests in the fund that would absorb more than an insignificant amount of the fund's expected variability. Because the fees are customary and commensurate and do not expose the general partner to risk of loss, and because the other interests are not significant, the fees are not variable interests.
- However, the general partner's 5% direct and approximately 1% indirect equity interests are variable interests.

2.3.8.3 Exposure to Risk of Loss

FASB REFERENCES

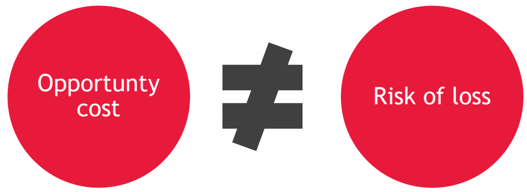
ASC 810-10-55-37C

Fee arrangements that expose a decision maker or service provider to risk of loss cause the fees to be variable interests, even if the fees are customary and commensurate and the decision maker or service provider does not have other interests that would absorb more than an insignificant amount of the legal entity's expected variability.

Examples of arrangements that expose a decision maker or service provider to losses include:

- Guarantees of the value of the legal entity's assets or liabilities
- Obligations to fund the legal entity's operating losses
- Payments for written put options on the legal entity's assets
- Liquidity commitments or similar obligations (explicit or implicit) that protect other variable interest holders from suffering losses in the legal entity

Exposure to losses differs from the opportunity cost of not receiving fees. For example, a fee arrangement that allows an investment fund manager to participate only in the fund's returns and that meets all the conditions in Section 2.3.8 is not a variable interest, even though the manager may not receive fees when the fund has losses.



Example 2-15 illustrates a fee arrangement that exposes the decision maker to risk of loss.

EXAMPLE 2-15: DECISION-MAKER FEE ARRANGEMENT WITH RISK OF LOSS

FACTS

- The reporting entity enters a three-year offshoring arrangement with a legal entity, which is an offshore delivery center.
  - The offshoring arrangement gives the reporting entity exclusive access to the legal entity's employees; the legal entity cannot enter a similar offshoring arrangement with other entities.
  - The reporting entity pays the legal entity for each hour the legal entity's employees work on the reporting entity's projects and for each hour the employees are not assigned to a project because of project delays or cancellations.
  - The legal entity was designed to follow regulations prohibiting foreign ownership in the country where it is domiciled and to create and pass along operations risk to the reporting entity.
- The reporting entity also receives decision-maker fees for managing the legal entity's workforce (including hiring, firing, and managing employees), which is the activity that most significantly impacts the legal entity's economic performance.
  - The decision-maker fees are customary and commensurate.
  - The reporting entity does not have other interests in the legal entity.

CONCLUSION

The reporting entity's fee arrangement is a variable interest.

ANALYSIS

- The legal entity was designed to create and pass along operations risk to its interest holders.
- The legal entity's purpose and design is to follow regulations prohibiting foreign ownership in the country where it is domiciled; the bench time fees paid by the reporting entity protect the legal entity's equity owners from incurring operating losses caused by insufficient project workload.
- Regardless of the likelihood of paying for bench time, the reporting entity is exposed to risk of loss, so the fees are variable interests.

2.3.8.4 Reevaluating Whether Fees Are Variable Interests

While ASC 810 specifies events that trigger the reconsideration of whether a legal entity is a VIE (see Section 3.7) and requires continuous reevaluation of the primary beneficiary (see Section 4.5), there is no specific guidance for reevaluating whether fees are variable interests.

BDO INSIGHTS — REEVALUATING WHETHER FEES ARE VARIABLE INTERESTS

We believe a decision maker or service provider should evaluate all facts and circumstances when determining whether to reconsider whether its fees are variable interests, including:

Changes in the legal entity's purpose and design or activities	Changes to the terms of the decision-maker or service provider fee arrangement	Acquisition, issuance, or disposition of other interests

By analogy to the guidance on when to reconsider whether a legal entity is a VIE (see Section 3.7), we believe a change solely in the legal entity's economic performance does not trigger a reevaluation of whether fees are variable interests. For example, a decision maker or service provider does not reevaluate whether its fees are variable interests simply because the legal entity incurs higher than expected losses. Similarly, fees are not reevaluated simply because of a change in the market rate for the services. However, if these fact patterns were also accompanied by other changes (such as a change in the legal entity's purpose and design, a substantive amendment to the terms of the fee arrangement, or a change in the significance of other interests), we believe the decision maker or servicer provider should reevaluate whether its fees are variable interests.

2.4 INTEREST IN SPECIFIED ASSETS

FASB REFERENCES

ASC 810-10-20: Variable Interests and ASC 810-10-25-55 through 25-56

The concept of an interest in specified assets is important to understand when applying the VIE model. Variable interests 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.*" Because the VIE model focuses on consolidating a legal entity, not individual assets, ASC 810 includes conditions for determining whether an interest in specified assets is a variable interest in a legal entity as a whole (see Section 2.4.1).

Examples of potential interests in specified assets include:

- Equity held by the reporting entity that tracks or pays a return solely based on the performance of specified assets of the legal entity
- A forward contract to buy an asset owned by the legal entity for an amount other than fair value
- A purchase option held by the reporting entity on an asset owned by the legal entity, exercisable at an amount other than fair value
- A legal entity's option to put an asset it owns to the reporting entity, exercisable at an amount other than fair value
- A reporting entity's residual value guarantee on an asset owned by the legal entity

2.4.1 Determine Whether an Interest in Specified Assets is a Variable Interest in the Entity as a Whole

FASB REFERENCES

ASC 810-10-25-55

An interest in specified assets of a legal entity is a variable interest in that entity as a whole if **either** of two conditions is met:

- The fair value of the specified assets is more than half the fair value of the legal entity's total assets.
- The holder has another variable interest in that legal entity as a whole (except for insignificant interests or interests with little variability).

Otherwise, the interest is not a variable interest in the legal entity as a whole. However, an interest in specified assets can still affect the consolidation analysis (see Section 2.4.2).

BDO INSIGHTS — DETERMINING WHETHER AN EXPOSURE IS MORE THAN HALF THE FAIR VALUE

If a reporting entity is exposed only to part of the variability of specified assets, we believe the reporting entity compares the fair value of the entire asset (not just the exposure) to the fair value of the legal entity's assets.

For example, assume a lessee guarantees that the leased asset, which has a fair value of $1 million at the assessment date, will have a residual value of at least $750,000 at the end of the lease term. When determining whether the lessee has a variable interest in the lessor legal entity as a whole, the reporting entity (regardless of whether it is the lessee or another variable interest holder in the lessor legal entity) would compare $1 million (not $750,000) to the fair value of the lessor legal entity's total assets.

A reporting entity may have an interest in more than one specified asset of a legal entity. If so, we believe the reporting entity compares the fair value of all its interests in specified assets to the fair value of the legal entity's total assets, instead of individually evaluating each interest (see Example 2-18).

AN INTEREST IN SPECIFIED LIABIILTIES DOEES NOT EXIST

The concept of an interest in specified liabilities does not exist in the VIE model. If a reporting entity is exposed to the variability of a specific liability of a legal entity (for example, by guaranteeing the legal entity's debt), it has a variable interest regardless of the size of that exposure or whether it holds other variable interests in the legal entity. The reporting entity is exposed (through the guarantee) to changes in the fair value of the legal entity's net assets and to the legal entity's ability to pay its debt.

Examples 2-16 through 2-18 illustrate the evaluation of whether an interest in specified assets is a variable interest in the legal entity as a whole.

EXAMPLE 2-16: AN INTEREST IN SPECIFIED ASSETS THAT IS MORE THAN 50% OF THE FAIR VALUE OF THE LEGAL ENTITY'S ASSETS

FACTS

A reporting entity guaranteed the residual value of a legal entity's only asset, which is a warehouse.

CONCLUSION

The residual value guarantee is a variable interest in the legal entity as a whole.

ANALYSIS

- The warehouse is the legal entity's only asset, so its fair value is more than 50% of the fair value of the legal entity's assets. Therefore, the first condition is met.
- Because one condition is met, the interest in specified assets (the residual value guarantee on the warehouse) is a variable interest in the legal entity as a whole.

EXAMPLE 2-17: AN INTEREST IN SPECIFIED ASSETS AND ANOTHER VARIABLE INTEREST

FACTS

- A reporting entity guaranteed the residual value of a warehouse owned by a legal entity.
- The warehouse's fair value is $4 million, and the fair value of the legal entity's assets is $10 million.
- The reporting entity also owns 20% of the legal entity's equity.

CONCLUSION

The equity and the residual value guarantee are variable interests in the legal entity as a whole.

ANALYSIS

- The warehouse's fair value is 40% of the fair value of the legal entity's total assets, which is less than 50% of the fair value of the legal entity's total assets. Therefore, the first condition is not met.
- The reporting entity owns 20% of the legal entity's equity, which is a significant variable interest in that entity as a whole. Therefore, the second condition is met.
- Because one condition is met, the interest in specified assets (the residual value guarantee on the warehouse) is a variable interest in the legal entity as a whole.

EXAMPLE 2-18: MULTIPLE INTERESTS IN SPECIFIED ASSETS

FACTS

A reporting entity guaranteed the residual values of a warehouse and a factory owned by a legal entity as follows:

- The warehouse's fair value is $5 million, and the reporting entity guaranteed that its residual value will be at least $4 million.
- The factory's fair value is $6 million, which the reporting entity guaranteed in full.

The fair value of the legal entity's total assets is $19 million. The reporting entity does not have other variable interests in the legal entity.

CONCLUSION

The residual value guarantees on the warehouse and factory are variable interests in the legal entity as a whole.

ANALYSIS

- Even though the reporting entity guaranteed only that the warehouse's fair value will be at least $4 million, it includes the entire $5 million when determining whether it has a variable interest in the legal entity as a whole. The fair values of the warehouse ($5 million) and the factory ($6 million) are aggregated ($11 million) and compared to the fair value of the legal entity's total assets ($19 million). Because these variable interests collectively are more than half (58%) of the fair value of the legal entity's total assets, the first condition is met.
- Because one condition is met, the interests in specified assets (the residual value guarantees) are variable interests in the legal entity as a whole.

2.4.2 Effects of an Interest in Specified Assets

FASB REFERENCES

ASC 810-10-25-56

An interest in specified assets can affect the VIE analysis in several ways:

- Determining whether a legal entity has sufficient equity at risk (see Section 2.4.2.1)
- Determining whether the holders of the equity at risk collectively have the obligation to absorb losses (see Section 2.4.2.2)
- Identifying the primary beneficiary of a VIE (see Section 2.4.2.3)

2.4.2.1 Effect of an Interest in Specified Assets on the Sufficiency of Equity at Risk

FASB REFERENCES

ASC 810-10-15-14(a) and ASC 810-10-25-56

As discussed in Section 3.2, when determining whether a legal entity is a VIE, a reporting entity must evaluate whether the equity at risk is insufficient for the legal entity to finance its activities without additional subordinated financial support (if so, it is a VIE). Evaluating the sufficiency of equity at risk involves comparing the legal entity's expected losses to its equity at risk. An interest in specified assets is considered in that evaluation as follows:

The fair value of the specified assets is >50% of the fair value of the legal entity's assets.	Expected losses absorbed by the variable interest are expected losses of the legal entity.	**Example:** The fair value of a leased asset is 60% of the fair value of the legal entity's total assets; therefore, expected losses absorbed by a residual value guarantee on the leased asset **are** expected losses of the legal entity.
The fair value of the specified assets is ≤50% of the fair value of the legal entity's assets.	Expected losses absorbed by that interest are **not** expected losses of the legal entity.	**Example:** The fair value of a leased asset is 40% of the fair value of the legal entity's total assets; therefore, expected losses absorbed by a residual value guarantee on the leased asset are **not** expected losses of the legal entity.

Example 2-19 illustrates the effect of an interest in specified assets when evaluating the sufficiency of equity at risk.

EXAMPLE 2-19: EFFECT OF AN INTEREST IN SPECIFIED ASSETS ON SUFFICIENCY OF EQUITY AT RISK

FACTS

- A legal entity was formed and financed with minimal equity and loans from two unrelated lenders. It used the proceeds to buy a warehouse and a factory, which it leased to Investor A and Investor B, respectively. The transaction was set up through a single legal entity to obtain better financing and maximize tax efficiencies.
- Investor A and Investor B guaranteed the residual values of their respective leased assets.
- Investor A and Investor B have no other variable interests in the legal entity.
- There are no silos (see Section 2.5).

(IN MILLIONS)	FAIR VALUE	EXPECTED LOSSES
Warehouse	$ 45	$ 15
Factory	10	5
Total	$ 55	$ 20

CONCLUSION

The equity, both loans, and Investor A's residual value guarantee on the warehouse are variable interests. Investor B's residual value guarantee on the factory is an interest in specified assets (not a variable interest in the legal entity as a whole). The legal entity's expected losses are $15 million when evaluating the sufficiency of the legal entity's equity at risk.

ANALYSIS

- The equity and both loans are variable interests (see Sections 2.3.1 and 2.3.2, respectively).
- The warehouse's fair value ($45 million) is more than half the fair value of the total assets ($55 million); therefore, Investor A's residual value guarantee is a variable interest in the legal entity as a whole.
- The factory's fair value ($10 million) is less than half the fair value of the legal entity's total assets ($55 million) and Investor B does not have other variable interests in the legal entity, so its residual value guarantee is not a variable interest in the legal entity as a whole (it is an interest in specified assets).
- The legal entity's expected losses are $15 million when evaluating the sufficiency of equity at risk, which excludes the $5 million of expected losses related to the interest in specified assets (the factory) that is less than half the fair value of the legal entity's assets.

2.4.2.2 Effect of an Interest in Specified Assets on the Equity Holders' Obligation to Absorb Expected Losses

FASB REFERENCES

ASC 810-10-15-14(b)(2) and ASC 810-10-25-56

An interest in specified assets can also affect whether the holders of the equity at risk collectively lack the obligation to absorb the legal entity's expected losses (if so, the legal entity is a VIE; see Section 3.4).

The fair value of the specified assets is >50% of the fair value of the legal entity's assets. →	Expected losses absorbed by the variable interest are expected losses of the legal entity. →	**Example:** The fair value of a leased asset is 60% of the fair value of the legal entity's total assets. Therefore, a residual value guarantee on that leased asset is a variable interest in that entity as a whole, which **protects** the holders of the equity at risk collectively from absorbing the legal entity's expected losses. As a result, the legal entity is a VIE.
The fair value of the specified assets is ≤50% of the fair value of the legal entity's assets. →	Expected losses absorbed by that interest are **not** expected losses of the legal entity. →	**Example:** The fair value of a leased asset is 40% of the fair value of the legal entity's total assets. Therefore, a residual value guarantee on that leased asset is an interest in specified assets that does **not** protect the holders of the equity at risk from collectively absorbing the legal entity's expected losses, because losses related to that asset are not considered expected losses of the legal entity. Further evaluation is needed to determine whether the legal entity has other VIE characteristics (see Section 3.1).

2.4.2.3 Effect of an Interest in Specified Assets on the Identification of the Primary Beneficiary

FASB REFERENCES

ASC 810-10-25-38A(b) and ASC 810-10-25-56

A reporting entity with a variable interest in a VIE must identify the primary beneficiary, which requires determining whether the reporting entity has economics (the obligation to absorb the VIE's losses or the right to receive benefits from the VIE that could potentially be significant to the VIE; see Section 4.3).

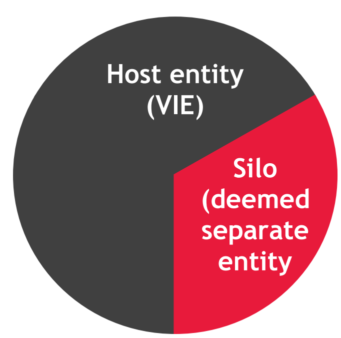
The fair value of the specified assets is >50% of the fair value of the legal entity's assets. →	Expected losses absorbed by the variable interest are expected losses of the legal entity. →	**Example:** The fair value of a leased asset is 60% of the fair value of the legal entity's total assets; therefore, expected losses related to a residual value guarantee on that leased asset (which is a variable interest in that entity as a whole) are **included** when identifying the primary beneficiary and evaluating economics.
The fair value of the specified assets is ≤50% of the fair value of the legal entity's assets. →	Expected losses absorbed by that interest are **not** expected losses of the legal entity. →	**Example:** The fair value of a leased asset is 40% of the fair value of the legal entity's total assets; therefore, expected losses related to a residual value guarantee on that leased asset (which is an interest in specified assets) are **excluded** when identifying the primary beneficiary and evaluating economics.

2.5 SILOS

FASB REFERENCES

ASC 810-10-25-57 through 25-58

A reporting entity with an interest in specified assets of a VIE treats part of the VIE as a deemed VIE (that is, as if it were a separate legal entity) if the specified assets are essentially the only source of payment for specified liabilities or specified other interests (for example, equity). A separate VIE is considered to exist only if essentially all the assets, liabilities, and equity of the deemed VIE are separate from the host VIE and specifically identifiable, that is, if essentially none of the returns of the assets of the deemed VIE can be used by the remaining host VIE and essentially none of the deemed VIE's liabilities are payable from the assets of the host VIE. The deemed VIE is generally called a "silo."



Specified assets and related liabilities secured only by the specified assets are **not** a silo if other parties have rights or obligations related to the specified assets or to residual cash flows from the specified assets.

Additionally, the host entity must be a VIE for a silo to exist (see Section 2.5.1).

BDO INSIGHTS — APPLYING THE ESSENTIALL ALL THRESHOLD

U.S. GAAP does not define the phrase “essentially all.” However, some practitioners have interpreted the phrase to mean that 95% or more of the deemed VIE’s assets, liabilities, and equity are separate from the host VIE. Accordingly, silos are rare, but they most often arise in response to compliance with specific laws or regulations, or in structures designed to isolate the risks and rewards related to specific assets and liabilities. For example, individual cells in a core cell captive insurance company and individual series funds that are not otherwise considered separate legal entities (as discussed in Section 1.2.2 and Section 2.5.1), are often but not always silos. Determining whether the essentially all threshold is met requires the application of professional judgment based on the facts and circumstances.

2.5.1 Determine Whether the Host Is a VIE

FASB REFERENCES

ASC 810-10-25-57 through 25-58

For a silo to exist, the host entity must be a VIE (see Chapter 3 for the characteristics of a VIE).

BDO INSIGHTS — DETERMINING WHETHER THE HOST IS A VIE

When a silo is present, by design the host entity often has only nominal other activities, assets, or equity, and its equity holders may not have the ability to direct activities that most significantly impact its economic performance. As a result, the host entity often is a VIE because:

- It has insufficient equity at risk (see Section 3.2).
- A party with an interest in specified assets has substantive participating rights. Therefore, the holders of equity at risk of the host entity collectively lack the power to direct the activities that most significantly impact the host entity’s economic performance (see Section 3.3).

An excerpt from a January 2016 letter to the SEC staff addresses this topic.

SEC STAFF GUIDANCE

Letter from SIFMA to Wesley Bricker, SEC Deputy Chief Accountant

> *If the individual series funds do not meet the definition of a legal entity for consolidation purposes [as discussed in Section 1.2.2], then the umbrella should be assessed to determine whether it is a voting interest entity or a variable interest entity (VIE). In performing this assessment, the guidance on interests in specified assets and silos in ASC 810-10-25-55 through 25-58 should be applied.*
>
> *Accordingly, if the umbrella has no assets, liabilities or equity other than that which relates to individual series (e.g., the fair value of the specified assets of each of the individual series within the umbrella is not more than half of the total fair value of the umbrella’s assets) the SEC Staff would not object to a view that the umbrella is a VIE. Under this view, the variable interests in specified assets (i.e., the equity of each series) would generally not represent*

equity investment at risk of the umbrella for purposes of applying the guidance in ASC 810-10-15-14. Consequently, the umbrella would meet the condition of ASC 810-10-15-14b since interests other than equity investment at risk (i.e., equity of each series) provide the holders of that investment with power, and, accordingly, the umbrella would be considered a VIE.

If the umbrella is a VIE, then each silo (i.e., individual series fund) would be evaluated for consolidation as a separate VIE in accordance with ASC 810-10-25-57.

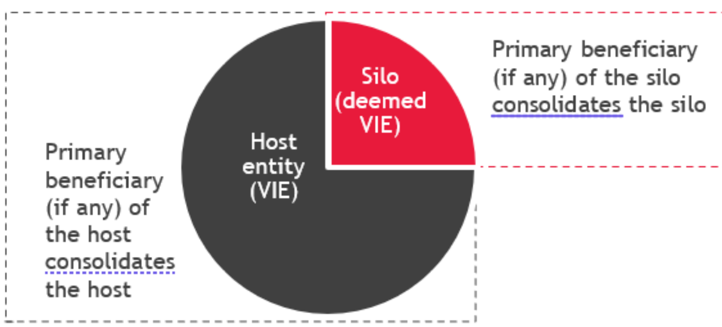
2.5.2 Identify the Primary Beneficiary of the Silo and the Host Entity

FASB REFERENCES

ASC 810-10-25-57

The primary beneficiary of a silo is identified using the same approach used for other VIEs (see Chapter 4). The primary beneficiary of a silo can be the same as, or different from, the primary beneficiary of the host entity.

- The primary beneficiary of a silo, if any, consolidates the silo. We believe no other parties should consolidate the silo, even if the silo does not have a primary beneficiary. It would be inappropriate for the primary beneficiary of a host entity to recombine the silo with the host entity to consolidate both, even if the silo does not have a primary beneficiary of its own.
- Variable interest holders in the host entity exclude the silo's activities and economics when identifying the primary beneficiary of the host entity. The primary beneficiary of the host entity consolidates the host entity, excluding the silo.



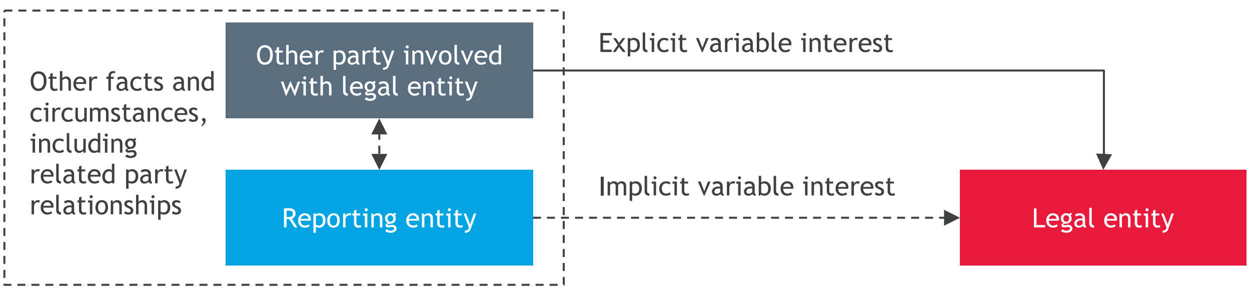
2.6 IMPLICIT VARIABLE INTERESTS

FASB REFERENCES

ASC 810-10-25-49 through 25-54 and ASC 810-10-55-25

According to ASC 810-10-25-51, "*an implicit variable interest is an implied pecuniary interest in a VIE that changes with changes in the fair value of the VIE's net assets exclusive of variable interests.*" Implicit variable interests generally arise from transactions or relationships with related parties and de facto agents (but could also arise in transactions with other parties). An implicit variable interest exists when a reporting entity **indirectly** absorbs a legal entity's expected variability because of other arrangements, relationships, or facts and circumstances. For example, an implicit variable interest may exist if facts and circumstances indicate a reporting entity could be compelled to absorb the legal entity's losses to protect another variable interest holder.

The diagram shows the concept of an implicit variable interest.



The guidance in ASC 810-10-25-49 through 25-54 prevents a reporting entity from circumventing the VIE model just by absorbing variability indirectly through an arrangement with another variable interest holder, instead of directly from the legal entity.[5]

Examples of potential implicit variable interests include:

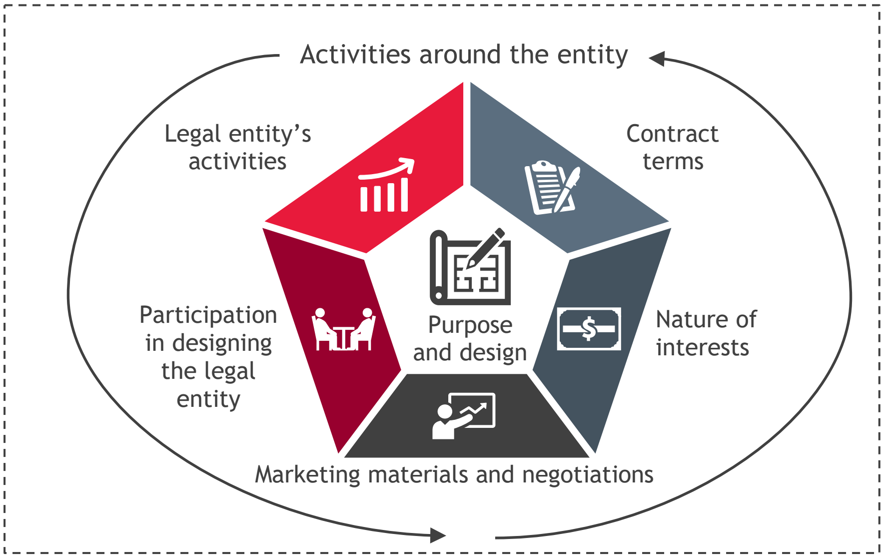
- Leases that do not explicitly require the lessee to absorb the lessor legal entity's variability; even so, the lessee is implicitly obligated to do so based on the leased asset's importance to the lessee and the lessor legal entity's purpose and design
- Implicit guarantees of the value of the legal entity's assets or liabilities
- Implicit agreements to replace the legal entity's impaired assets

However, when an implicit variable interest relates only to specified assets of a legal entity, the reporting entity must determine if it is a variable interest in that entity as a whole (see Section 2.4).

[5] Mark Northan, Professional Accounting Fellow, SEC, AICPA National Conference on Current SEC and PCAOB Developments (December 5, 2005).

Determining whether an implicit variable interest exists requires the application of professional judgment based on the facts and circumstances, including the legal entity's purpose and design (see Section 2.2.2.2), contract terms, and the activities around the legal entity.[6] The significance of the reporting entity's involvement and the size of its interest in the legal entity are not determinative in identifying implicit variable interests. **There are no bright lines**.

This table provides some questions that may be relevant when evaluating whether a reporting entity has an implicit variable interest in a legal entity.



	QUESTIONS	IMPLICATIONS
Participation in designing the legal entity	Are other parties related to the reporting entity? For example: ▶ Are they under common control? ▶ Does a director or officer of the reporting entity have a variable interest in the legal entity? ▶ Did two or more parties enter a contract (for example, a loan, equity) creating a related party or de facto agency relationship? ▶ Are few parties involved; are they known to each other?	It is important to understand the nature of the relationship and each party's ability to fully pursue its own interests. The greater latitude a reporting entity has to pursue its own interests, the less likely an implicit variable interest exists.
Legal entity's activities	What are the constraints or expectations in the environment or industry in which the legal entity operates? For example: ▶ Can banking regulators, the SEC, or other regulatory agencies compel or force the parties to act in a specific way (or threaten action if they do not act in a specific way)? ▶ Is there a past practice of behaving in a specific manner by the reporting entity or other parties in similar arrangements? ▶ How unique are the legal entity's assets or operations, and how significant are those assets or operations to the other parties?	Understanding how regulators, customers, and other participants in the structure can compel, force, or expect each party to behave is important. The more a party can be compelled, forced, or is expected to act to protect another party, the more likely an implicit variable interest exists.

[6] Jane D. Poulin, Associate Chief Accountant, SEC Office of the Chief Accountant, 2004 AICPA National Conference on SEC and PCAOB Developments (December 6, 2004) (see excerpt in Section 3.2.2.4).

	QUESTIONS	IMPLICATIONS
Terms of contracts	What terms do parties expect to apply to the contracts and arrangements? For example: ▶ Is there a customary practice in the industry participants expect a party to uphold? ▶ Is there a common feature or term usually present in similar arrangements in the industry?	It is important to understand the terms that regulators and other variable interest holders expect to apply to a contract (even when they are absent). The more a party is expected to act to protect another party, the more likely an implicit variable interest exists.
Nature of interests	How do the structure and terms of interests and arrangements incentivize or protect the various parties involved? For example: ▶ Do the economics flow to the same parent? ▶ Does the structure share economics or protect parties directly involved with the legal entity? ▶ Are there economic incentives or significant barriers (for example, potential defaults on loan covenants) if the parties act in a specific way?	It is important to understand how each party directly or indirectly involved absorbs expected residual returns or is protected from absorbing expected losses. The more a party can be compelled or is incentivized to act to protect another party, the more likely an implicit variable interest exists.
Marketing materials and negotiations	What are the terms of the arrangements between the parties and why did they enter the arrangements with each other instead of with the legal entity? Additionally: ▶ Did parties enter the arrangement in contemplation of the legal entity's formation? ▶ Was the arrangement contemporaneous with issuing a variable interest?	It is important to understand the terms of arrangements between the parties and why they entered the arrangement with each other instead of with the legal entity. The more affirmative answers to the questions at left, the more likely that an implicit variable interest exists — but these factors are not determinative.

IMPLICIT VARIABLE INTERESTS DO NOT AUTOMATICALLY RESULT IN CONTROL

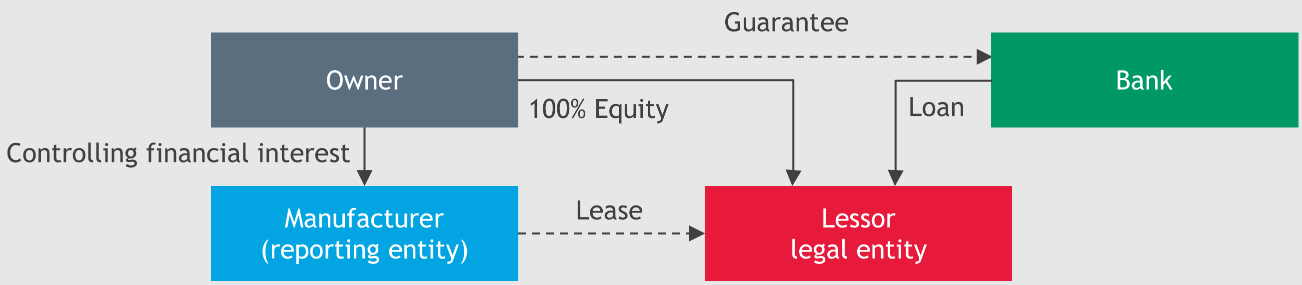
A reporting entity with an implicit variable interest in a legal entity does not necessarily control that entity. Further analysis is required, including evaluating whether the legal entity is a VIE (see Chapter 3) and, if so, identifying its primary beneficiary (see Chapter 4). All facts and circumstances must be considered, including the legal entity's purpose and design, the reasons why the implicit variable interest was not entered directly with the legal entity, whether stated power is substantive, and the relationships between the parties. Reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

Example 2-20 illustrates a potential implicit variable interest.

EXAMPLE 2-20 (ADAPTED FROM ASC 810-10-55-88 THROUGH 55-89, SUPERSEDED): IMPLICIT VARIABLE INTEREST

FACTS

- An owner has a controlling financial interest in a manufacturer, which is the reporting entity.
- The owner also holds 100% of the lessor legal entity's equity.
- The owner guaranteed the lessor legal entity's loan from a bank.
- The lessor legal entity's only asset is a manufacturing facility, which is leased to the manufacturer.
- The operating lease has at-market terms and does not contain an explicit residual value guarantee or a fixed-price purchase options, so the manufacturer does not have an explicit variable interest in the lessor legal entity (see Section 2.3.6).
- No other contractual relationships exist between the manufacturer and the lessor legal entity.



CONCLUSION

The manufacturer must determine whether it holds an implicit variable interest in the lessor legal entity (more information is needed in this example). If the manufacturer has a variable interest in the lessor legal entity, it determines whether the lessor legal entity is a VIE and, if so, whether the manufacturer is its primary beneficiary.

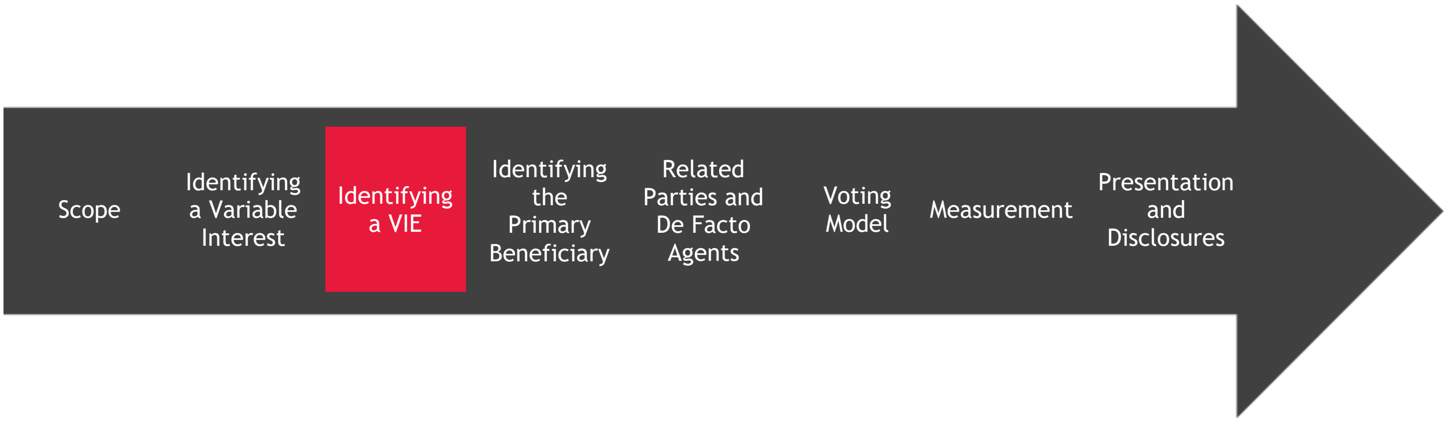
ANALYSIS

- The manufacturer may have an implicit variable interest in the lessor legal entity if the manufacturer is expected to:
  - Effectively guarantee the owner's investments in the lessor legal entity
  - Make funds available to the lessor legal entity to prevent the owner's guarantee from being called
  - Make funds available to the owner if necessary to perform (pay) under its guarantee of the loan
- To determine whether an implicit variable interest exists, the manufacturer considers all facts and circumstances, including:
  - The owner's economic incentives for the manufacturer function as a guarantor or make funds available
  - A history of such actions in similar situations
  - A conflict of interest or legal prohibition against such actions

BDO INSIGHTS — RELIEF FROM THE VIE MODEL FOR SOME PRIVATE COMPANIES

Identifying implicit variable interests and evaluating how they affect consolidation conclusions can be challenging and may involve significant judgment. Private companies may elect the private company accounting alternative (see Section 1.4.5) to legal entities that meet specified conditions. If elected, the private company must apply the alternative to all legal entities that meet the conditions for that scope exception.

Chapter 3 — Identifying a VIE



3.1 OVERVIEW

Once a reporting entity determines that it has a variable interest in a legal entity in the scope of the VIE model, it next determines whether the legal entity is a VIE. If a legal entity is not a VIE, the reporting entity evaluates whether it controls the legal entity in accordance with the voting model or other general subsections of ASC 810 (see Chapter 6).

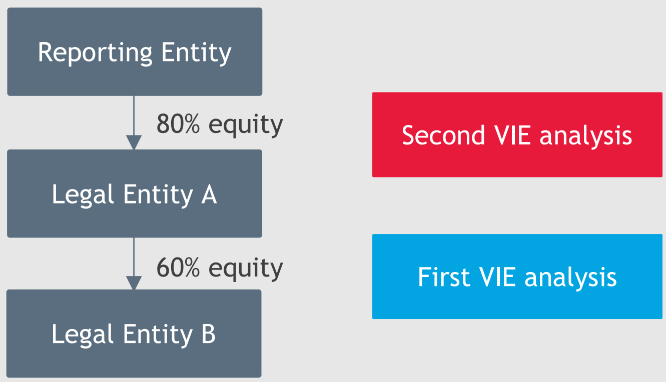
Identifying which model to apply is important because the models may result in different consolidation conclusions. The usual condition in the voting model for a controlling financial interest in a legal entity is ownership of a majority voting interest. However, that condition is not effective in identifying a controlling financial interest for some legal entities. The VIE model is designed to identify legal entities structured so the equity holders do not have the normal risks, rewards, and decision-making rights that generally belong to equity holders. Therefore, a reporting entity must apply the VIE model if the legal entity has **any** characteristics of a VIE listed in the following table.

CHARACTERISTIC		GUIDANCE
Equity at risk	The equity at risk is insufficient to finance the legal entity's activities without additional subordinated financial support.	Section 3.2
Power	The holders of the equity at risk **collectively** lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the legal entity's economic performance.	Section 3.3
Expected losses	The holders of the equity at risk **collectively** lack the obligation to absorb the legal entity's expected losses.	Section 3.4
Expected residual returns	The holders of the equity at risk **collectively** lack the right to receive the legal entity's expected residual returns.	Section 3.5
Voting rights are nonsubstantive	The voting rights are nonsubstantive because **both** criteria are met: ▶ The voting rights of some investors are not proportional to their economic exposure to the legal entity. ▶ Substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights, including that investor's related parties and specific de facto agents.	Section 3.6

ASC 810 does not require a reporting entity to evaluate the VIE characteristics in sequence. If a legal entity appears to have one characteristic of a VIE, it may be more efficient to evaluate that characteristic first because the legal entity is a VIE if it has any VIE characteristics. On the other hand, for a legal entity to be a voting interest entity, it cannot have **any** VIE characteristics (the reporting entity must evaluate all five VIE characteristics).

A reporting entity determines whether a legal entity is a VIE when it first becomes involved with the legal entity, based on the legal entity's purpose and design. After the initial determination, the reporting entity reassesses whether the legal entity is a VIE only upon a reconsideration event (see Section 3.7). A legal entity does not become a VIE solely because it incurs operating losses. That said, losses that reduce the equity at risk may increase the likelihood of a reconsideration event (for example, restructuring debt). Therefore, a reporting entity should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances that could affect its analysis.

BDO INSIGHTS — VIE ASSESSMENT IN TIERED STRUCTURES



A reporting entity may need to evaluate whether a legal entity in a multitiered structure is a VIE. In these scenarios, a question arises as to the sequence of the VIE assessment and whether the reporting entity may disregard the intermediary entities.

We believe a reporting entity should generally begin its assessment at the lowest level in a structure and move up (the bottoms-up approach). In this example, the reporting entity first evaluates whether Legal Entity B is a VIE (and, if so, identifies its primary beneficiary) and then evaluates whether Legal Entity A is a VIE (and, if so, identifies its primary beneficiary).

However, as discussed in Section 5.2.1, sometimes (for example, in asset management, private equity, and similar industries) it may be necessary to first determine the nature of the relationship between upper-tier entities directly or indirectly involved with a VIE, including whether they are under common control.

3.2 INSUFFICIENT EQUITY AT RISK

FASB REFERENCES

ASC 810-10-15-14(a), ASC 810-10-20: Subordinated Financial Support, Expected Losses

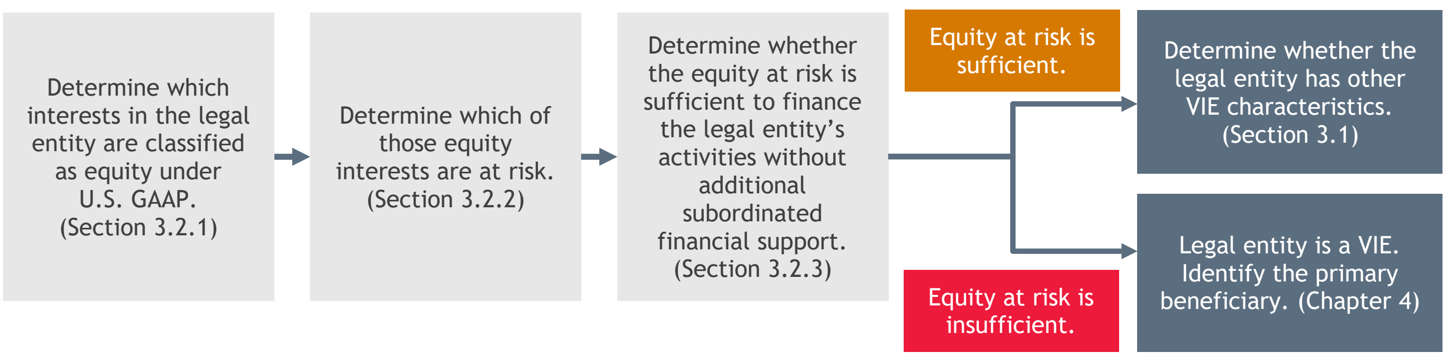
Equity at risk

A legal entity is a VIE if the equity at risk is insufficient to finance the legal entity's activities without additional subordinated financial support.

Subordinated financial support is a variable interest that "*will absorb some or all of a variable interest entity's (VIE's) expected losses.*" Expected losses are "*the expected negative variability in the fair value of [the legal entity's] net assets exclusive of variable interests*" (see Section 2.2.2.1).

Subordinated financial support includes equity instruments, most debt (see Section 2.3.2), contractual agreements with off-market terms, guarantees (see Section 2.3.3), commitments to fund the legal entity, and some derivatives (see Section 2.3.4). Subordinated financial support generally excludes senior debt with an investment-grade credit rating (or, if not rated, with similar characteristics) that exposes the creditor to a minimal risk of default.

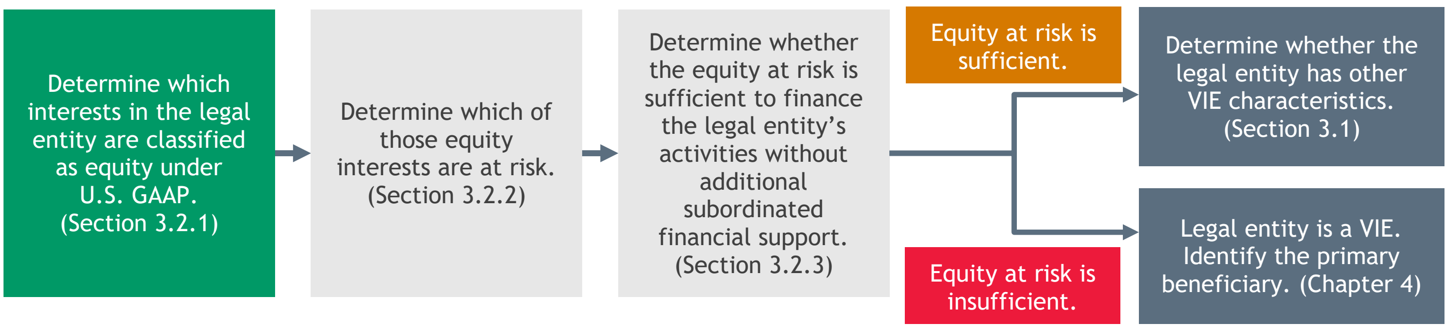
To determine whether a legal entity has insufficient equity at risk, a reporting entity can follow this flowchart.



3.2.1 Determine Which Interests in the Legal Entity Qualify as Equity in U.S. GAAP

FASB REFERENCES

ASC 810-10-15-14(a) and ASC 480-10-S99-3A



The first step in determining whether the legal entity's equity at risk is sufficient is to determine which interests in the legal entity are classified as equity in its financial statements in accordance with U.S. GAAP. The following table lists the classification of common instruments. However, determining whether an instrument is classified as equity or as a liability requires the application of professional judgment based on the facts and circumstances.

GENERALLY CLASSIFIED AS EQUITY	GENERALLY NOT CLASSIFIED AS EQUITY
▶ Common stock ▶ Limited partnership units ▶ Membership interests in an LLC ▶ Perpetual preferred stock ▶ Contingently redeemable preferred shares classified as temporary (mezzanine) equity in accordance with ASC 480, Distinguishing Liabilities From Equity	▶ Legal-form debt ▶ Commitments to fund equity ▶ Unfunded capital calls ▶ Subscription agreements ▶ Commitments to fund the legal entity's losses ▶ Preferred shares or membership interests classified as liabilities in accordance with ASC 480 ▶ Beneficial interests in securitization entities (see Note 1) ▶ Guarantees

Note 1: Beneficial interests in a securitization vehicle include senior and subordinated shares of interest, principal, or other cash inflows, as well as residual interests, which are usually issued in a certificate. However, these beneficial interests have contractual recourse only to the CFE's assets and generally are classified as financial liabilities. A securitization vehicle generally does not have more than nominal equity (therefore, a securitization vehicle generally is a VIE because the equity at risk is insufficient).

CLASSIFYING FINANCIAL INSTRUMENTS CAN BE COMPLEX

Legal-form equity instruments may have features that cause liability classification in U.S. GAAP (for example, under ASC 480 or ASC 815-40, *Derivatives and Hedging — Contracts in Entity's Own Equity*). Determining whether such instruments are classified as equity or liabilities can be complex. See BDO's publication, Understanding Complex

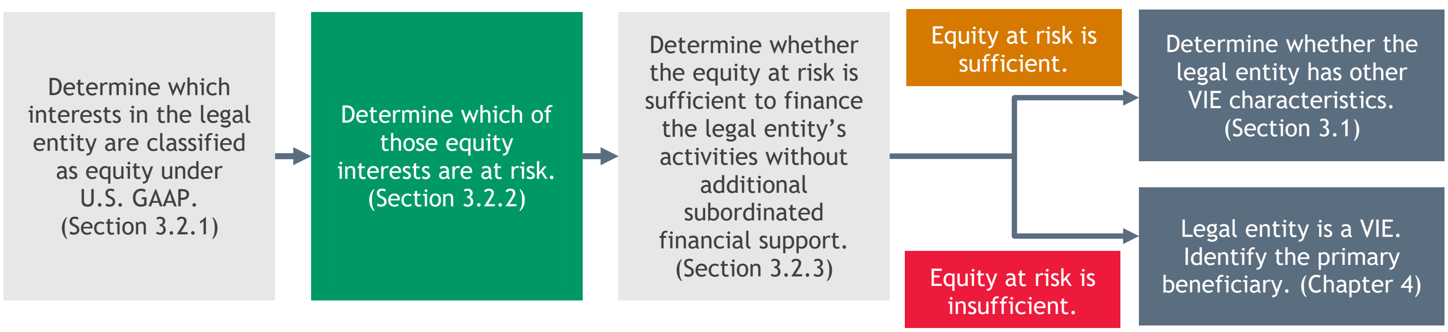
Financial Instruments, for guidance. When determining whether a legal entity has sufficient equity at risk, equity-classified instruments are evaluated further (see Section 3.2.2); liability-classified instruments are excluded.

3.2.2 Determine Which Equity is at Risk

FASB REFERENCES

ASC 810-10-15-14(a)

The second step in determining whether a legal entity has sufficient equity at risk is to evaluate which equity-classified instruments are at risk.



To be equity at risk, an equity-classified instrument must meet **all** the criteria below.

	It participates significantly in both profits and losses (see Section 3.2.2.1).
	It is not issued in exchange for subordinated interests in another VIE (see Section 3.2.2.2).
	It is not directly or indirectly provided to the equity investor by the legal entity or other parties involved with the legal entity (see Section 3.2.2.3).
	It is not directly financed for the equity investor by the legal entity or other parties involved with the legal entity (see Section 3.2.2.4).

INTERESTS IN SILOS

When an interest in a legal entity's specified assets is essentially the only source of payment for specified liabilities or other interests of that legal entity and the host entity is a VIE, a silo exists (see Section 2.5). A host entity often has no assets, liabilities, or equity other than related to the silos (for example, individual series funds). In those cases, the equity interests in the silos may not be considered equity at risk in the host entity, which may cause the host entity to have no or minimal equity at risk. A legal entity needs at least **some** equity at risk to be a voting interest entity. As a result, a host entity often is a VIE. This view is consistent with issues discussed by the SEC staff and SIFMA in the context of consolidation analyses for international series funds (see Section 2.5.1).

3.2.2.1 Equity Participates Significantly in Both Profits and Losses

FASB REFERENCES

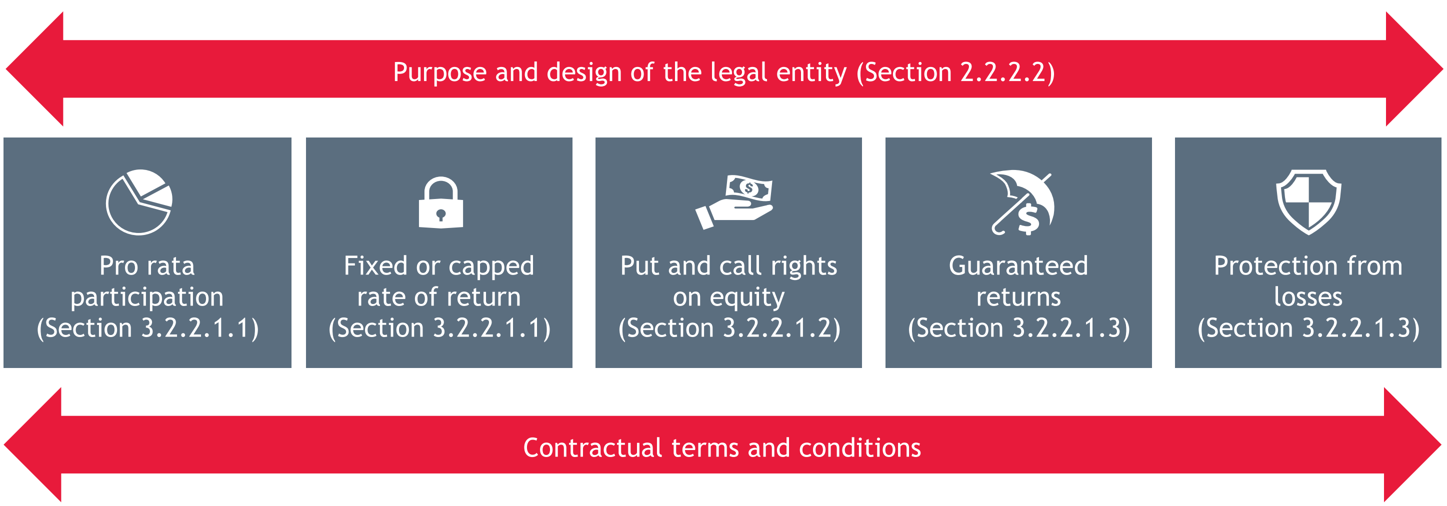
ASC 810-10-15-14(a)(1)

The equity must participate significantly in both profits and losses to be equity at risk. Whether it carries voting rights is irrelevant. Equity that participates significantly only in profits **or** only in losses is not equity at risk.

For example, while common stock generally participates significantly in both profits **and** losses, a warrant on common stock generally is not exposed to risk of loss. Therefore, a warrant may not participate significantly in both profits and losses (and therefore may not be equity at risk). Likewise, some preferred stock participates significantly in profits and losses (for example, preferred stock with rights to receive distributions on an as-converted basis), while other preferred stock may not participate significantly in profits (for example, preferred stock with low fixed distribution rights).

While the VIE model generally focuses on whether a variable interest is exposed to the legal entity's expected variability, which is the changes in the fair value of the legal entity's net assets (see Section 2.2.2.1), this criterion requires the equity to share in the legal entity's U.S. GAAP net income or loss to be equity at risk.

To determine whether the equity participates significantly in profits and losses, a reporting entity considers all of the equity instrument's terms and conditions, including those described below (as applicable), within the context of the legal entity's purpose and design.



3.2.2.1.1 Pro Rata Participation or Fixed or Capped Rates of Return

If equity participates in profits and losses pro rata and is substantive (not inconsequential), it generally participates significantly in profits and losses.

If the equity does not participate pro rata, but is subject to the risk of total loss, it generally is considered to participate significantly in losses. In contrast, if the equity has a fixed or capped rate of return, the nature and extent of the fixed return or cap is evaluated in the context of the legal entity's purpose and design (for example, based on the expected returns on the legal entity's equity) to determine whether the investor participates significantly in profits.

If the fixed rate of return or cap is reasonably close to the expected return on equity, the equity participates significantly in profits.	Evaluate other at risk criteria
If the fixed rate of return or cap is significantly lower than the expected return on equity, the equity does not participate significantly in profits.	The equity is **not** at risk

Concluding that equity participates significantly in profits when the equity instrument has a fixed rate of return or is subject to a cap requires the application of professional judgment based on the facts and circumstances.

Examples 3-1 and 3-2 illustrate the evaluation of whether equity participates significantly in profits and losses.

EXAMPLE 3-1: EQUITY WITH PRO RATA PARTICIPATION IN PROFITS AND LOSSES

FACTS

- Investor A contributed $200,000 to a legal entity in exchange for 1% of the legal entity's equity, which shares in profit and losses pro rata.

CONCLUSION

Investor A's equity participates significantly in profits and losses and is equity at risk if the other criteria are met (see Section 3.2.2).

ANALYSIS

- Investor A participates in profits and losses proportionately to its equity ownership interest, which is considered substantive even though 1% might not be considered significant in other evaluations. Because Investor A's equity participates significantly in both profits and losses, it is equity at risk if the other criteria are met (see Section 3.2.2).
- In contrast, a nominal investment (such as $100) is not substantive and therefore is not equity at risk.

EXAMPLE 3-2: EQUITY WITH A FIXED RATE OF RETURN

FACTS

A legal entity is initially capitalized with the following classes of equity-classified instruments (in order of seniority):

- Series B preferred stock — 3% fixed rate of return (or dividend) and a liquidation preference equal to the Series B original issue price plus accrued but unpaid 3% returns
- Series A preferred stock — 7% fixed rate of return (or dividend) and a liquidation preference equal to the Series A original issue price plus accrued but unpaid 7% returns
- Common stock — receives residual returns after Series A and Series B and is substantive (not inconsequential)

The expected return on the legal entity's equity is 8%.

CONCLUSION

The Series A preferred stock and common stock participate significantly in both profits and losses and are equity at risk if the other criteria are met (see Section 3.2.2). The Series B preferred stock does not participate significantly in profits and therefore is not equity at risk.

ANALYSIS

- The Series A investors are entitled to a fixed rate of return that is reasonably close to the expected return on equity. Therefore, the Series A preferred stock participates significantly in profits. The Series A preferred stock also participates significantly in losses because it is subject to the risk of total loss. Because the Series A preferred stock participates significantly in both profits and losses, it is equity at risk if the other criteria are met (see Section 3.2.2).
- The Series B investors are entitled to a fixed rate of return that is significantly lower than the expected overall return on equity. Therefore, the Series B preferred stock does not participate significantly in profits and is not equity at risk.
- The common stock investors absorb variability after Series A and B investors earn their preferred returns, so the common stock participates significantly in profits. The common stock also participates significantly in losses because it is substantive (not inconsequential), and subject to the risk of total loss. Because the common stock participates significantly in both profits and losses, it is equity at risk if the other criteria are met (see Section 3.2.2).

3.2.2.1.2 Put or Call Rghts on Equity

Some equity is subject to a put or call right held by the investor, the legal entity, or other parties. The put or call right may be embedded in the equity itself or arise from a separate agreement (for example, a separate put option or call option).

BDO INSIGHTS — EVALUATING THE EFFECTS OF PUT AND CALL RIGHTS ON EQUITY

Put or call rights may prevent an equity instrument from participating significantly in losses or profits if they limit the investor's exposure to losses or profits. Factors to consider in this evaluation include:

- The legal entity's purpose and design (see Section 2.2.2.2)
- Whether the right is entered into at the legal entity's formation
- Whether the right is freestanding or embedded in the equity
- The relationship with the counterparty (for example, the legal entity itself, another party involved with the legal entity, a related party or de facto agent of those parties, or a third party with no involvement with the legal entity or other parties involved in the arrangement)
- Whether the right is contingent or noncontingent.
- The exercise price (for example, fair value, fixed price, or based on a formula) and position (for example, deeply out of the money, in the money), considering that:
  - A put or call option with a fair value exercise price generally does not prevent the equity from being at risk
  - A put right might also cause the equity to be considered to be financed for the holder (see Section 3.2.2.4), in which case the equity is not at risk

Reaching a conclusion about whether such rights prevent equity from participating significantly in profits or losses requires the application of professional judgment based on the facts and circumstances.

Example 3-3 illustrates the evaluation of whether equity participates significantly in profits and losses.

EXAMPLE 3-3: EQUITY WITH A PUT RIGHT

FACTS

- Investor A and Investor B formed a legal entity to manufacture a new product. Investor A contributed machinery and equipment with a fair value of $1 million, and Investor B contributed $1 million in cash.
- Each investor holds 50% of the legal entity's equity. In accordance with the legal entity's governing documents, the equity holders participate in profit and losses pro rata.
- Because of the risks of launching the new product, the governing documents give Investor B the right to put its equity back to the legal entity at a specified future date for $1 million.

CONCLUSION

Investor B's equity does not participate significantly in losses and therefore is not equity at risk.

ANALYSIS

- Investor B is shielded from exposure to the legal entity's losses because it can put its equity to the legal entity and receive its initial investment of $1 million. Therefore, Investor B's equity does not participate significantly in losses and is not equity at risk.

3.2.2.1.3 Guaranteed Returns and Other Forms of Protection From Losses

When the terms of the equity instrument guarantee the investor a minimum return, the equity may not participate significantly in the legal entity's losses. We believe:

If the guaranteed return or protection is from a third party not involved with the legal entity (and not a related party or de facto agent of involved parties), the guarantee or arrangement may not prevent the equity from participating in losses.	✓ Evaluate other at risk criteria
If the guaranteed return or protection is from the legal entity or another party involved with the legal entity (or that is a related party or de facto agent of involved parties), the guarantee generally prevents the equity from participating in losses.	✗ The equity is **not** at risk

Reaching a conclusion about whether a guaranteed return or other terms protect equity from participating significantly in losses requires the application of professional judgment based on the facts and circumstances.

3.2.2.2 Equity Is not Issued in Exchange for Subordinated Interests in Another VIE

FASB REFERENCES

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

Equity issued by the legal entity in exchange for subordinated interests in another VIE is not equity at risk.

For example, Investor A bought $1 million of equity in Entity B, which is a VIE. Investor A then contributed its equity in Entity B to Entity C in exchange for equity in Entity C (Entity B became an investee of Entity C). In this case, Investor A's equity in Entity C is not equity at risk. An equity interest is equity at risk for only one legal entity.

3.2.2.3 Equity is Not Provided to the Equity Investor by the Legal Entity or Other Parties Involved

FASB REFERENCES

ASC 810-10-15-14(a)(3)

Equity at risk excludes amounts directly or indirectly paid or provided to the equity investor by the legal entity or other parties involved with the legal entity, unless that party is a parent, subsidiary, or affiliate in the same set of consolidated financial statements as the investor.

Equity at risk generally excludes fees, charitable contributions, or other payments to the investor in cash or other consideration (for example, by issuing share-based payments in the scope of ASC 718). Such payments prevent the equity from being at risk because the investor is not exposed to risk of loss.

BDO INSIGHTS — DETERMINING WHETHER FEES PAID TO AN EQUITY INVESTOR CAUSE EQUITY NOT TO BE AT RISK

Reaching a conclusion about whether fees paid to an equity investor are a return of investment and therefore cause all or a portion of the equity not to be at risk requires the application of professional judgment based on the facts and circumstances, including:

Timing	▶ Fees paid to an equity investor before services are provided (whether in cash or equity) reduce the investor's equity at risk unless the parties that paid the fees have the substantive right to claw back the payments if the services are not provided. • For example, equity granted in exchange for services provided by the investor is often referred to as "sweat equity." Such equity is not at risk because it is financed by the legal entity. ▶ Fees that are at-market and paid over time as substantive services are provided (whether in cash or equity) do not reduce the investor's equity at risk.
Contingencies	▶ Fees contingent on providing substantive services in the future or on substantive events, or upfront fees that may be clawed back if substantive services are not provided in the future (whether in cash or equity) generally do not reudce the investor's equity at risk. ▶ Fees that are not contingent on providing substantive services in the future (or other events), or that cannot be clawed back if substantive services are not provided in the future reduce the investor's equity at risk. We believe such amounts should be discounted to their present value.
Customary and commensurate	▶ Fees that are customary and commensurate with the services provided (see Section 2.3.8.1) generally do not reduce the equity at risk (if the fees are not paid up front and are contingent on providing substantive services, as discussed above). ▶ Fees that in excess of customary and commensurate amounts reduce the investor's equity at risk.

Examples 3-4 through 3-6 illustrate the evaluation of whether equity is at risk as a result of amounts directly or indirectly provided to the equity investor by the legal entity or other parties involved with the legal entity.

EXAMPLE 3-4: CASH PAID TO THE EQUITY INVESTOR

FACTS

- Investor A and Investor B formed a legal entity, and each contributed $50,000 in cash in exchange for 50% of the legal entity's equity ($100,000 in total).
- In conjunction with the legal entity's formation, the legal entity paid an upfront fee of $50,000 in exchange for Investor A's promise to provide services in the future to the legal entity.

CONCLUSION

The legal entity's equity at risk is $50,000 if the other criteria are met (see Section 3.2.2).

ANALYSIS

- Investor A's equity is not at risk because the upfront service fee is a contemporaneous return of its initial investment.
- Investor B's equity is at risk if the other criteria are met (see Section 3.2.2).

EXAMPLE 3-5: FEES PAID TO THE EQUITY INVESTOR

FACTS

Investor A and Investor B formed a legal entity. Investor A contributed $1 million in cash in exchange for 50% of the legal entity's equity and is entitled to receive from the legal entity:

- Administration fees of $100,000 payable at inception.
- Management fees of $20,000 paid monthly for 36 months. Management fees in similar contracts for similar services in the market are $15,000 per month.
- Exit fees of $500,000 if the legal entity completes an IPO within two years.

This example ignores the time value of money.

CONCLUSION

Investor A's equity at risk is $720,000 if the other criteria are met (see Section 3.2.2).

ANALYSIS

- The administration fee of $100,000 received at inception reduces the equity at risk.
- The management fees exceed the customary terms for commensurate services in the market by $5,000 per month ($20,000 less the $15,000 market rate). Accordingly, the fees exceeding the market rate reduce the equity at risk ($5,000 * 36 = $180,000). The at-market fees of $15,000 do not reduce the equity at risk because they are paid as Investor A provides substantive services.
- The exit fee contingent on an IPO does not reduce the equity at risk because there is a substantive risk the contingent event will not occur.
- Therefore, Investor A reduces the cash paid for its investment of $1 million by $280,000 ($100,000 + $180,000), so only $720,000 of its equity is at risk if the other criteria are met (see Section 3.2.2).

EXAMPLE 3-6: SWEAT EQUITY

FACTS

- Investor A and Investor B formed a legal entity.
- Investor A entered a management agreement with the legal entity in exchange for receiving 10% of its equity.
- The equity is nonforfeitable and is the only compensation for services rendered by Investor A.

CONCLUSION

Investor A's equity is not equity at risk.

ANALYSIS

- Investor A's equity is not equity at risk because it is issued at inception, before Investor A has provided services, and is nonforfeitable.

3.2.2.3.1 Equity Provided in Exchange for Intangible Assets

A reporting entity may contribute intangible assets to a legal entity in exchange for its equity. The equity is at risk if the intangible assets are identifiable and qualify for separate recognition in accordance with ASC 805 (they meet either the separability criterion or the contractual-legal criterion).

Example 3-7 illustrates equity at risk issued in exchange for intangible assets.

EXAMPLE 3-7: EQUITY RECEIVED IN EXCHANGE FOR INTANGIBLE ASSETS

FACTS

Investor A and Investor B formed a legal entity. In exchange for receiving some of the legal entity's equity, Investor A contributes $7 million in cash and the following intangible assets:

- Patented technology with a fair value of $8 million registered by Investor A and licensed to third parties
- Computer software with a fair value of $5 million developed by Investor A

CONCLUSION

Investor A's equity at risk is $20 million if the other criteria are met (see Section 3.2.2).

ANALYSIS

- The patented technology meets the contractual-legal criterion, and the computer software meets the separability criterion, so these intangible assets qualify for separate recognition in accordance with ASC 805.
- Therefore, Investor A's equity at risk includes cash ($7 million), the fair value of the technology ($8 million), and the fair value of the software ($5 million) if the other criteria are met (see Section 3.2.2).

3.2.2.4 Equity is Not Financed for the Equity Investor by the Legal Entity or Other Parties Involved

FASB REFERENCES

ASC 810-10-15-14(a)(4)

Equity financed for the equity investor (for example, through loans or guarantees of loans) by the legal entity or another party involved with the legal entity is not equity at risk. However, amounts financed for the investor by a parent, subsidiary, or affiliate in the same set of consolidated financial statements as the investor are still equity at risk (similar to the exception discussed in Section 3.2.2.3).

Example 3-8 illustrates whether equity is at risk because of financing by the legal entity or another party involved with the legal entity.

EXAMPLE 3-8: EQUITY FINANCED ON THE INVESTOR'S BEHALF

FACTS

- Investors A, B, C, and D invest in a legal entity formed by Group BB (Investor B's parent).
- Each investor contributed $100,000 in exchange for 25% of the legal entity's equity.
- It used the proceeds of $400,000 and a loan of $600,000 from Bank 1 to buy manufacturing equipment and materials.
- Bank 1 also loaned $60,000 to Investor A for its investment in the legal entity.
- Group BB financed Investor B's equity in the legal entity.
- Investor B provided a financial guarantee to Investor C for $30,000. Investors B and C are not affiliates.
- Investor D financed its investment in the legal entity with a loan from Bank 2, which is not involved with the legal entity or a related party or de facto agent of any of the parties.

CONCLUSION

The equity at risk in the legal entity is:

	U.S. GAAP EQUITY	EQUITY AT RISK
Investor A	$ 100,000	$ 40,000
Investor B	100,000	100,000
Investor C	100,000	70,000
Investor D	100,000	100,000
Total	$ 400,000	$ 310,000

ANALYSIS

- Investor A's equity at risk is $40,000. Bank 1 is involved with the legal entity (as a result of its $600,000 loan to the legal entity) and partially financed Investor A's equity investment. Therefore, the $60,000 financed by Bank 1 on Investor A's behalf is not equity at risk, leaving only $40,000 ($100,000 - $60,000) of its equity at risk if the other criteria are met (see Section 3.2.2).
- Investor B's equity at risk is $100,000. Even though Group BB financed Investor B's entire equity investment, Group BB is Investor B's parent. Therefore, the financing does not prevent Investor B's equity from being at risk if the other criteria are met.
- Investor C's equity at risk is $70,000. Investor C received a financial guarantee from Investor B, which is involved with the legal entity. Therefore, $30,000 is not equity at risk, leaving only $70,000 ($100,000 - $30,000) of its equity at risk if the other criteria are met.
- Investor D's equity at risk is $100,000. Even though Bank 2 financed Investor D's equity investment, Bank 2 is not related to or involved with Investors A, B, and C or the legal entity. Therefore, Bank 2's loan does not prevent Investor D's equity from being at risk if the other criteria are met.

Equity subject to put or call options or total return swaps with the legal entity or a party involved with the legal entity requires evaluation and may not be equity at risk. It is important to consider the legal entity's purpose and design; activities around the legal entity, as discussed by the SEC staff; and the factors discussed in Section 3.2.2.1.2. Reaching a conclusion about whether put or call options or total return swaps cause equity not to be at risk requires the application of professional judgment based on the facts and circumstances.

SEC STAFF GUIDANCE

[Remarks before the 2004 AICPA Conference on Current SEC and PCAOB Developments]

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> *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.*[7] *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 short answer is no. First, FIN 46R 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 and whether the at risk holders possess the characteristics of a controlling financial interest as defined in paragraph 5(b) of FIN 46R. 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 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 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.* [Footnotes omitted.]

[7] FIN 46R refers to FASB Interpretation No. 46, *Consolidation of Variable Interest Entities: An Interpretation of ARB No. 51* (revised December 2003). Although some aspects of FIN 46R were superseded before being codified as part of ASC 810, with some aspects superseded, we believe the concepts discussed in this speech remain relevant in current U.S. GAAP.

BDO INSIGHTS — A PUT RIGHT CAN CREATE A DE FACTO AGENCY RELATIONSHIP

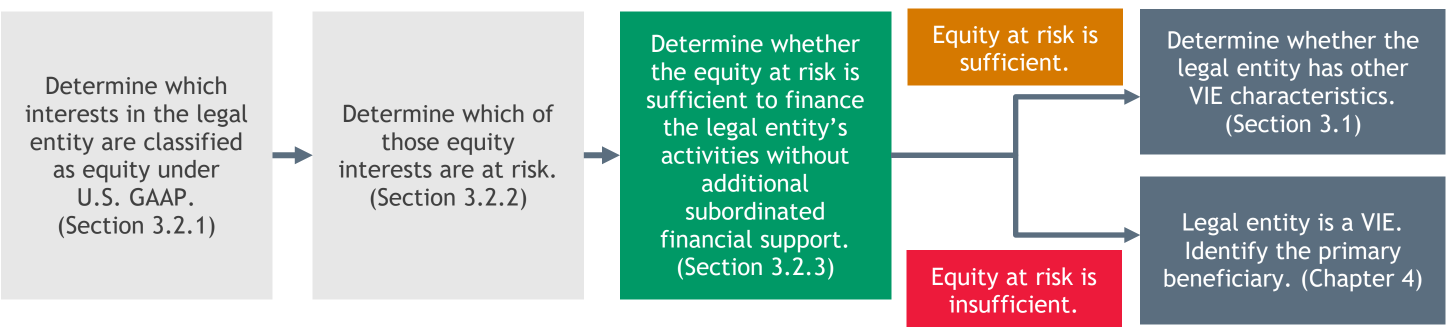
A put right can prevent an equity instrument from participating significantly in losses because it might limit the investor's exposure to expected losses (see Section 3.2.2.1.2). Further, a put right may be a means of financing an equity investment in a legal entity. In both cases, the put right results in the equity not being at risk.

Additionally, if a put right is deemed a financing of the investor's equity, that financing would also create a de facto agency relationship (see Section 5.3.2) between the equity holder and the counterparty. Reaching a conclusion about whether equity is financed requires the application of professional judgment based on the facts and circumstances.

3.2.3 Determine Whether the Equity at Risk Is Sufficient to Finance the Legal Entity's Operations

FASB REFERENCES

ASC 810-10-15-14(a), ASC 810-10-20: Expected Losses, Subordinated Financial Support, ASC 810-10-25-45 through 25-46, and ASC 810-10-25-56



If the equity at risk is insufficient for the legal entity to finance its activities without additional subordinated financial support, the legal entity is a VIE, as summarized in the graphic. This can be determined qualitatively or quantitatively.

Fair value of equity at risk > expected losses	Equity at risk is sufficient (the legal entity does not have this characteristic of a VIE); determine whether the legal entity has any other VIE characteristics.
Fair value of equity at risk < expected losses	Equity at risk is insufficient (the legal entity is a VIE); identify the primary beneficiary.

When performing this step, expected losses related to an interest in specified assets are not the legal entity's expected losses if the fair value of the specified assets is less than 50% of the fair value of the legal entity's total assets (see Section 2.4.2.1).

Subordinated financial support is defined as "*variable interests that will absorb some or all of a variable interest entity's (VIE's) expected losses.*" Expected losses are "*the expected negative variability in the fair value of [the legal entity's] net assets exclusive of variable interests*" (see Section 2.2.2.1). Subordinated financial support includes equity instruments, most debt (see Section 2.3.2), contractual agreements with off-market terms, guarantees (see

Section 2.3.3), commitments to fund the legal entity, and some derivatives (see Section 2.3.4). Subordinated financial support generally excludes senior debt with an investment-grade credit rating (or, if not rated, with similar characteristics) that expose the creditor to a minimal risk of default.

There is a rebuttable presumption that equity at risk of less than 10% of the legal entity's total assets is insufficient for the legal entity to finance its activities without additional subordinated financial support. However, some legal entities need equity at risk of more than 10% of their assets to finance their activities, especially if they engage in high-risk activities, hold high-risk assets, or are exposed to risks not reflected in the measurements in the financial statements. Therefore, having more equity at risk than 10% of total assets does not necessarily mean the legal entity has sufficient equity at risk.

BE CAREFUL BEFORE RELYING ON THE 10% THRESHOLD

Parties often incorrectly assume that if the legal entity has more than 10% of equity at risk, the equity at risk is automatically sufficient. However, that was not the FASB’s intent; the FASB referenced a 10% threshold to demonstrate that the 3% threshold previously applied was insufficient for most VIEs. [8]

Some legal entities may require equity at risk of more than 10%.[9] Therefore, equity at risk greater than 10% is not a safe harbor and does not relieve a reporting entity of its responsibility for determining whether the legal entity has sufficient equity at risk. On the other hand, while having equity at risk of less than 10% does not necessarily prevent a reporting entity from concluding that a legal entity has sufficient equity at risk, we believe persuasive evidence is needed to rebut the presumption.

Therefore, a reporting entity must determine whether the legal entity’s equity is sufficient regardless of whether equity at risk is more or less than 10% of a legal entity’s assets.

ASC 810 describes three methods for determining whether equity at risk is sufficient.

Qualitative assessment	Method 1: Demonstrate that the legal entity can finance its operations without additional subordinated financial support (see Section 3.2.3.1).
Qualitative assessment	Method 2: Demonstrate that the legal entity has at least as much equity at risk as similar entities (those that hold only similar assets (in quality and amount) operating without additional subordinated financial support (see Section 3.2.3.2).
Quantitative assessment	Method 3: Demonstrate that equity at risk exceeds the legal entity’s expected losses based on reasonable quantitative evidence (see Section 3.2.3.3).

The reporting entity may perform a qualitative analysis, a quantitative analysis, or a combination to demonstrate that equity at risk is sufficient. Qualitative assessments do not require detailed calculations or estimates and therefore generally take less effort than a quantitative assessment. A reporting entity generally can reach a conclusion using only a qualitative analysis without performing a quantitative assessment. A quantitative assessment is required only if a qualitative analysis is inconclusive in determining whether the legal entity has sufficient equity at risk.

[8] FIN 46R, paragraph E23.
[9] ASC 810-10-25-46.

BDO INSIGHTS — CONSIDERING REGULATORY REQUIREMENTS IN A QUALITATIVE ANALYSIS

Regulatory requirements (for example, minimum capitalization requirements) may be informative in a qualitative analysis, but they are not determinative. For example, banks, insurance companies, and other financial institutions generally are subject to minimum capital requirements set by regulators, which may be higher or lower than 10% of their assets. Compliance with minimum capital requirements is not determinative in concluding whether a legal entity has sufficient equity at risk. However, the reporting entity should consider any minimum capital requirements in its qualitative analysis because such requirements may indicate the capitalization levels that third parties consider sufficient.

3.2.3.1 Method 1: Demonstrate that the Legal Entity Can Finance its Operations Without Additional Subordinated Financial Support (Qualitatively)

FASB REFERENCES

ASC 810-10-25-45(a) and 25-47

The first qualitative method focuses on the legal entity's ability to finance its activities without additional subordinated financial support (that is, whether any financing other than equity comes from third-party lenders at market terms for investment-grade financing). This method is based on the presumption that creditors rate debt as investment-grade only if they believe a legal entity is sufficiently capitalized.

This analysis considers all facts and circumstances, including the legal entity's purpose and design and the other factors in the graphic (see Section 2.2.2.2). No single factor is determinative; reaching a conclusion that equity at risk is sufficient requires the application of professional judgment based on the facts and circumstances.

The below items may qualitatively indicate the equity at risk is insufficient.

Non-investment-grade debt and complex debt structures	When qualitatively evaluating whether the equity at risk is sufficient, a reporting entity evaluates the amounts, credit ratings, interest rates, maturity dates, redemption features, contingent interest features, and other terms of the debt, as well as the legal entity's capital structure. If a legal entity has debt that does not have an investment-grade credit rating (or, if not rated, similar characteristics), the legal entity may have insufficient equity at risk.
Guarantees	A financial guarantee given on the legal entity's behalf as a condition for a loan likely indicates that the lender believe the legal entity has insufficient equity at risk to secure repayment. Similarly, if the legal entity can get financing only with recourse to assets held by another entity, or another party guaranteed the value of the legal entity's assets, that likely indicates the legal entity has insufficient equity at risk.

Commitments to fund equity or losses	A commitment by investors to fund equity (for example, buy more shares or fund capital calls) or the legal entity's losses may indicate it has insufficient equity at risk. However, a commitment by investors to fund equity in the future does not automatically mean the legal entity has insufficient equity at risk. The reporting entity must consider the legal entity's purpose and design (see Section 2.2.2.2). For example, a commitment to fund additional equity to expand the legal entity's activities in the future may not indicate insufficient equity at risk based on the legal entity's **current** purpose and design. On the other hand, if a legal entity expects to need additional subordinated financial support to finance its current purpose and design, the investors' commitment to fund future equity would likely indicate it has insufficient equity at risk.

ASC 810 gives two contrasting examples:

- If a legal entity does not have a limited life and tightly constrained activities, if no unusual arrangements are designed to provide subordinated financial support, if its equity does not appear to be designed to require other subordinated financial support, and if it obtained commercial financing on customary terms, the equity at risk is likely sufficient.
- If a legal entity has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that effectively is a replacement for equity, the equity at risk generally is insufficient.

Examples 3-9 and 3-10 illustrate a qualitative evaluation of whether the legal entity can finance its operations without additional subordinated financial support.

EXAMPLE 3-9: INVESTMENT-GRADE DEBT

FACTS

- A legal entity, which has existed for many years, develops and sells real estate.
- The legal entity was initially capitalized with common and preferred shares, which are all equity at risk.
- To expand its presence in new geographical areas, the legal entity borrowed on a nonrecourse basis from an unrelated bank. The loan is investment-grade rated. No other variable interests exist in the legal entity.
- Because the legal entity undertook additional activities to obtain more assets, which may also increase its expected losses, the common and preferred shareholders must reconsider whether the legal entity is a VIE as of that date (see Section 3.7).

CONCLUSION

The legal entity has demonstrated its ability to finance its operations without additional subordinated financial support. Therefore, absent other factors to indicate otherwise, the legal entity's equity at risk is sufficient. The reporting entity must determine whether the legal entity has any other VIE characteristics as of the reconsideration date.

ANALYSIS

- The legal entity issued investment-grade debt, which qualitatively demonstrates that the legal entity is sufficiently capitalized to repay the loan, and that no variable interests other than equity at risk will absorb its expected losses.

EXAMPLE 3-10: COMPLEX DEBT STRUCTURE

FACTS

A legal entity was formed and financed with the following instruments:

- Common stock.
- Perpetual preferred stock.
- Noninvestment-grade debt that carries an interest rate much higher than market terms for a low-risk borrowing for the same amount and with the same maturity date. An investor provided a financial guarantee to the lender on the legal entity's behalf.

CONCLUSION

The legal entity does not have the ability to finance its operations without additional subordinated financial support, so its equity at risk is insufficient. The legal entity is a VIE.

ANALYSIS

- The legal entity issued debt that is below investment grade. An investor provided a financial guarantee on the legal entity's behalf so that it could get the loan.
- Accordingly, the legal entity cannot qualitatively demonstrate that it can finance its operations without additional subordinated financial support.

3.2.3.2 Method 2: Demonstrate That the Legal Entity Has at Least as Much Equity at Risk as Similar Entities (Qualitatively)

FASB REFERENCES

ASC 810-10-25-45(b)

The second qualitative approach for demonstrating the sufficiency of equity at risk is evaluating whether the legal entity has at least as much equity at risk as similar entities operating without additional subordinated financial support. If relevant, the factors below are considered when evaluating whether other entities are substantially similar to the legal entity.

- Geographic location and areas of operations (focusing on similarity of geopolitical or environmental risk)
- Size and composition (exposure to risk, type, concentration, liquidity) of assets
- Capitalization (priority and liquidation preferences) and debt (amount, maturity, terms)
- Liquidity and cash flows
- Regulatory environment and capital requirements
- Risks related to the industry, product, service lines, and nature of operations

Finding entities with substantially similar operations and economic characteristics to those of the legal entity is often challenging because the entities used for this evaluation can hold only similar assets (in quality and amount) to those of the legal entity and must not have subordinated financing. Reaching a conclusion that entities have substantially similar operations and economic characteristics requires the application of professional judgment based on the facts and circumstances.

3.2.3.3 Method 3: Demonstrate That Equity at Risk Exceeds Expected Losses (Quantitatively)

FASB REFERENCES

ASC 810-10-25-45

The third method for determining whether the equity at risk is sufficient is to quantitatively demonstrate that it exceeds the legal entity's expected losses. A reporting entity generally can reach a conclusion using only a qualitative analysis without performing a quantitative assessment. A quantitative assessment is required only if a qualitative analysis is inconclusive in determining whether the legal entity has sufficient equity at risk (see Section 3.2.3).

The quantitative assessment focuses on whether the equity at risk in the legal entity can absorb its expected losses or whether other interests absorb some of these losses, as summarized in the graphic.

Fair value of equity at risk > expected losses →	Equity at risk is sufficient (the legal entity does not have this characteristic of a VIE); determine whether the legal entity has any other VIE characteristics
Fair value of equity at risk < expected losses →	Equity at risk is insufficient (the legal entity is a VIE); identify the primary beneficiary

THE COMPLEXITY OF QUANTITATIVELY DETERMINING WHETHER EQUITY AT RISK IS SUFFICIENT

To quantitatively determine whether equity at risk is sufficient, the reporting entity must determine the fair value of the equity at risk at the evaluation date:

- When the evaluation date is the same as the legal entity's formation date, the equity's carrying amount may equal its fair value, excluding transaction costs.
- When a reporting entity becomes involved with the legal entity after its formation (or the legal entity has a reconsideration event (see Section 3.7)), the reporting entity assesses whether the legal entity is a VIE as of that date; in this case, the equity's fair value generally differs from its carrying amount.

The reporting entity also must quantitatively determine the expected losses, which are the expected negative variability in the fair value of the legal entity's net assets (excluding variable interests) as discussed in Section 2.2.2.1. Expected losses differ from losses recognized in accordance with U.S. GAAP.

Because of the significant assumptions and estimates involved, calculating the legal entity's expected losses, and measuring the fair value of the equity at risk is often complex, time-consuming, costly, and subjective. It may require the application of professional judgment and valuation expertise.

3.3 HOLDERS OF EQUITY AT RISK COLLECTIVELY LACK POWER

FASB REFERENCES

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

Power

A legal entity is a VIE if the holders of the equity at risk **collectively** lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the legal entity's economic performance.

The power characteristic must be assessed for the holders of the equity at risk **as a group**. A legal entity is not a VIE simply because an **individual** holder of equity at risk lacks power, as long as the holders of the equity at risk **collectively** have power. However, if decisions are made other than through the equity at risk (for example, a nonequity holder has a variable interest and the right to veto or participate in decisions about the activities that most significantly impact the legal entity's economic performance), the legal entity may be a VIE.

SEPARATE DECISION-MAKING RIGHTS CAN CAUSE A LEGAL ENTITY TO BE A VIE

When evaluating whether the holders of the equity at risk collectively lack power, the reporting entity considers only decision-making rights conveyed **through** the equity at risk. A legal entity may be a VIE if decision-making rights are conveyed through equity that is not at risk or through a contract (and such rights are not contingent on holding equity at risk). A legal entity is a VIE even if those decision-making rights are held by an investor that also holds equity at risk.

For example, an equity investor may also hold debt whose terms give the debt holder substantive veto rights over the activities that most significantly impact the legal entity's economic performance. Because the veto rights are not conveyed through the equity at risk, the holders of the equity at risk collectively lack power, even though the debt holder also holds equity at risk. Therefore, the legal entity is a VIE.

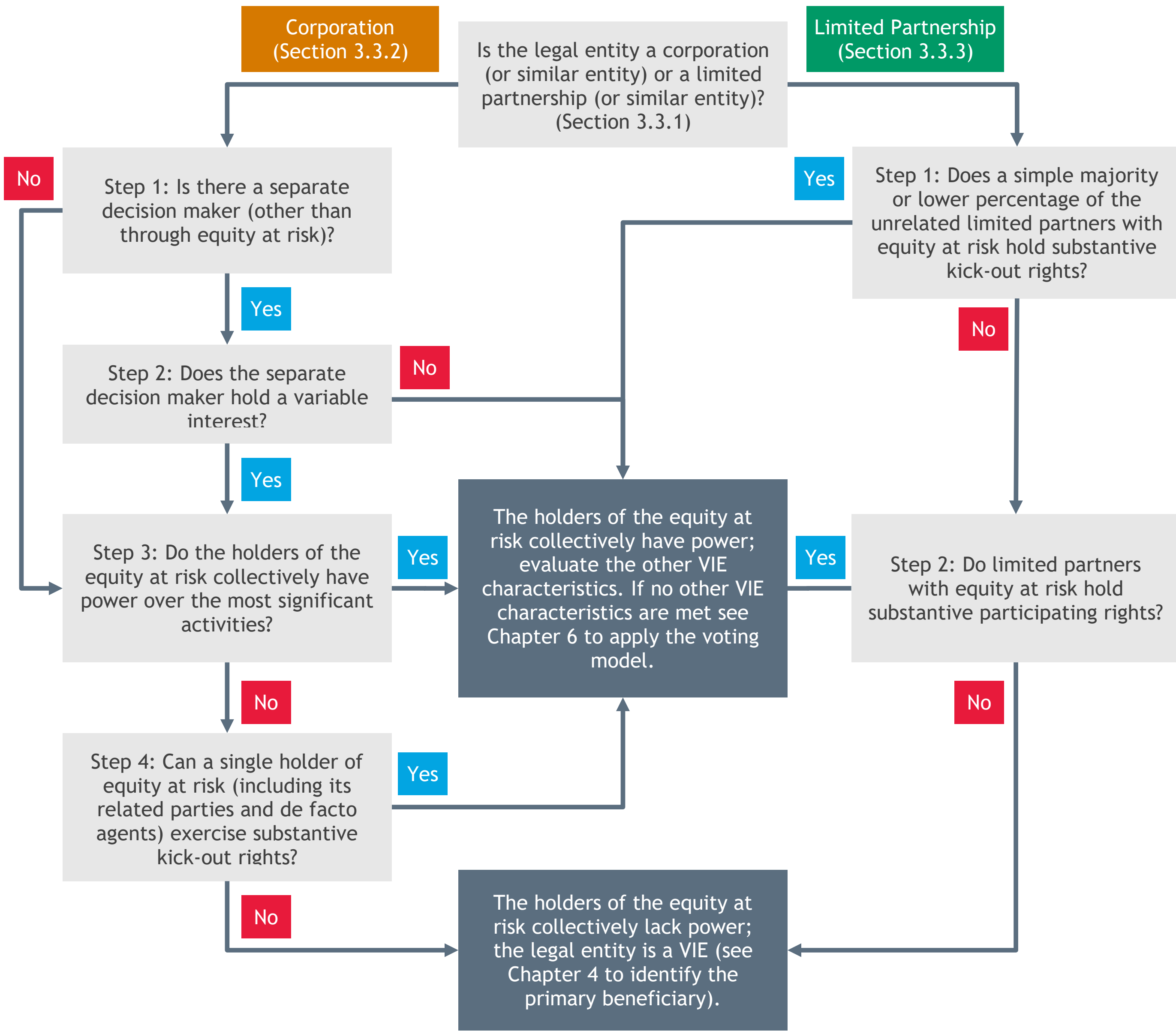
To assess the power characteristic, a reporting entity performs two steps.

Step 1: Analyze the nature of the risks in the legal entity (Section 2.2.1)

Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders (Section 2.2.2)

Considering these risks and the legal entity's purpose and design, the reporting entity evaluates whether the holders of the equity at risk collectively lack power. However, the next steps in this evaluation vary depending on whether the legal entity is a corporation (or similar entity) or a limited partnership (or similar entity). For example, an LLC may have a governance structure similar to a corporation or limited partnership. Determining whether a legal entity is more like a corporation or a limited partnership requires the application of professional judgment based on the facts and circumstances (see Section 3.3.1).

Once the reporting entity determines whether the legal entity is a corporation (or similar entity) or a limited partnership (or similar entity), the steps for determining whether the holders of the equity at risk collectively lack power are shown in the flowchart.



3.3.1 Determining Whether a Legal Entity is Like a Corporation or Limited Partnership

FASB REFERENCES

ASC 810-10-05-3, ASC 810-10-15-14(b)(1), ASC 323-30-35-3, and ASC 323-30-S99-1

To evaluate whether the holders of the equity at risk collectively lack power, the reporting entity must first determine whether the legal entity is like a corporation (or similar entity) or a limited partnership (or similar entity).

In ASC 810, any reference to a limited partnership includes a legal entity whose governance is like a limited partnership. Whether a legal entity is like a limited partnership depends on whether a single equity holder makes decisions about the limited partnership's significant financial and operating decisions based on its purpose and design (see Section 2.2.2.2).

LLCs generally have characteristics of both corporations and limited partnerships. For example, like the equity holders in a corporation, members of an LLC generally are not personally liable for the LLC's liabilities. On the other hand, an LLC generally is a nontaxable entity; its profits and losses are passed through to its members, which are taxed based on their share of the LLC's earnings, similar to limited partners. However, neither of these features relate to the LLC's governance, so a reporting entity disregards them when applying ASC 810. Instead, the reporting entity focuses on how decisions are made for the LLC and whether the managing member functions like a general partner and the non-managing members function like limited partners.

The managing member makes the legal entity's significant financial and operating decisions through its equity. → The LLC is evaluated like a limited partnership when determining whether the holders of the equity at risk (the LLC members) collectively lack power.

A managing member does not make the legal entity's significant financial and operating decisions (for example, the members or a board of managers make such decisions). → The LLC is evaluated like a corporation when determining whether the holders of the equity at risk (the LLC members) collectively lack power.

Determining whether an LLC (or any other legal entity) has a governance structure like that of a corporation or limited partnership requires the application of professional judgment based on the facts and circumstances. In this Blueprint, references to corporations include legal entities that are similar in governance to corporations, and references to limited partnerships include legal entities that are similar in governance to limited partnerships.

SEPARATE CAPITAL ACCOUNTS ARE NOT RELEVANT WHEN CLASSIFYING AN LLC

LLCs often have separate capital accounts for their members (similar to partnership capital accounts). Capital accounts are **not** a governance feature of an LLC; they are a feature of the members' economic rights and obligations. Therefore, the existence of capital accounts is **not** relevant when determining whether an LLC is like a limited partnership when applying ASC 810. However, if a reporting entity is not the primary beneficiary of an LLC with separate capital accounts, it may be required to apply the equity method to account for its investment if it holds more than a minor amount (3-5%) of the LLC's equity (see ASC 323-30-35-3 and ASC 323-30-S99-1).

Examples 3-11 and 3-12 illustrate the evaluation of whether an LLC is like a corporation or limited partnership.

EXAMPLE 3-11: ASSESSING WHETHER AN LLC IS LIKE A CORPORATION OR LIMITED PARTNERSHIP

FACTS

- Three investors formed an LLC to acquire, lease, and operate retail stores. The LLC was designed to create and pass along operations risk (from leasing and operating the stores) to its interest holders.
- In accordance with the governing documents, one investor is appointed as the managing member.
- All investors have equity at risk and appoint managers to the board.

The following table lists the LLC's activities, whether they are significant financial and operating decisions of the LLC (based on its purpose and design), and which party makes these decisions according to its governing documents.

DECISION	SIGNIFICANT?	BOARD OF MANAGERS	MANAGING MEMBER
Acquire retail stores	Yes		✓
Choose tenants and execute leases	Yes		✓
Hire, fire, and determine compensation of the LLC's management	Yes		✓
Determine the annual operating budget and capital budget	Yes		✓
Enter a new line of business	No	✓	
Sell substantially all the LLC's assets or liquidate the LLC	No	✓	
Amend the bylaws	No	✓	

CONCLUSION

The LLC is like a limited partnership. Using the steps in Section 3.3.3, the reporting entity evaluates whether the holders of the equity at risk collectively lack power.

ANALYSIS

- The LLC has a board of managers, which is a governance structure like in a corporation. However, the managing member (and not the board) makes the LLC's significant financial and operating decisions. The other activities do not relate to the LLC's significant financial and operating decisions, so the board's rights over those decisions are protective (see Section 3.3.3.2). Therefore, the LLC has a governance structure like a limited partnership.

EXAMPLE 3-12: ASSESSING WHETHER AN LLC IS LIKE A LIMITED PARTNERSHIP

FACTS

- Assume the same facts as in Example 3-11, except all significant financial and operating decisions are voted on by majority vote of the board, and one investor is appointed managing member to implement board decisions.

CONCLUSION

The LLC is like a corporation. Using the steps in Section 3.3.2, the reporting entity evaluates whether the holders of the equity at risk collectively lack power.

ANALYSIS

- The LLC has a board of managers that makes the LLC's significant financial and operating decisions. The investor's role as managing member of the LLC is to execute decisions made by the board. Therefore, the LLC has a governance structure like a corporation.

3.3.2 Evaluating Corporations and Similar Entities

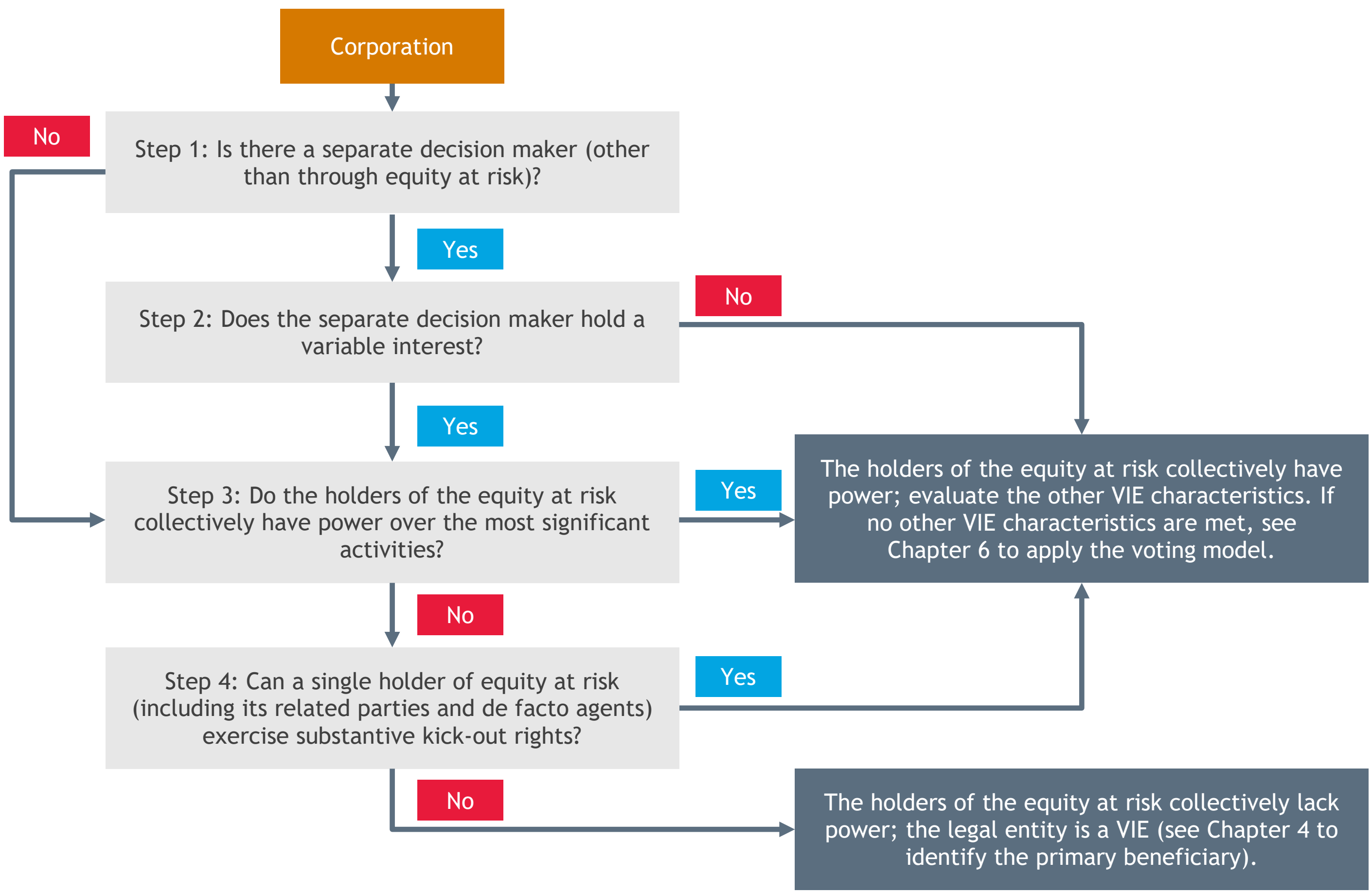
FASB REFERENCES

ASC 810-10-15-14(b)(1)(i) and ASC 810-10-20: Decision Maker

When the legal entity is a corporation, the evaluation of whether the holders of the equity at risk collectively lack power focuses on whether voting rights or similar rights held through the equity at risk allow the holders to direct the activities that most significantly impact the legal entity's economic performance. This evaluation is consistent with how power is assessed when identifying the primary beneficiary of a VIE (see Section 4.2) and requires the application of professional judgment based on the facts and circumstances.

Sometimes, a party other than a holder of equity at risk is the decision maker, or "*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*." When a decision maker has the right to direct **any** of the activities that most significantly impact the legal entity's economic performance through a variable interest that is not equity at risk, the legal entity is a VIE unless the holders of the equity at risk can remove the decision maker without cause.

The following flowchart (excerpted from the one in Section 3.3) shows the steps for determining whether the holders of the equity at risk of a corporation collectively lack power.



This table below summarizes considerations for the steps in the flowchart.

STEP	CONSIDERATIONS
Step 1: Is there a separate decision maker (other than through equity at risk)?	▶ The governing body of a corporation may outsource decision-making rights to a party through a separate agreement (a “separate decision maker”). If the separate decision maker has the right to direct at least one of the activities that most significantly impacts the legal entity’s economic performance (see Section 3.3.2.1), proceed to Step 2. If there is not a separate decision maker, proceed to Step 3. ▶ Reaching a conclusion about whether decision-making rights are contingent on holding the equity at risk (and therefore considered part of the equity) requires the application of professional judgment based on the facts and circumstances.
Step 2: Does the separate decision maker hold a variable interest?	▶ If the separate decision maker does not have a variable interest, the holders of the equity at risk are deemed to collectively have power (ASC 810-10-15-14(b)(1)(i)(01)). When fees paid to a decision maker are not variable interests (see Section 2.3.8), the decision maker is presumed to act as an agent on the equity holders’ behalf. If so, the legal entity does not have the power characteristic of a VIE. Determine whether the legal entity has other VIE characteristics. ▶ If the separate decision maker has a variable interest, proceed to Step 3.
Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?	▶ The holders of the equity at risk collectively have power if no other parties have decision-making rights or substantive participating rights (see Section 3.3.2.3). That power can be held by the holders of the equity at risk through voting rights (directly) through rights to appoint the legal entity’s board of directors (which votes on such activities) or through other similar rights. When the holders of the equity at risk collectively have power, determine whether the legal entity has other VIE characteristics. ▶ A separate decision maker does not prevent the holders of the equity at risk from having power if the holders collectively have substantive kick-out rights exercisable without cause (see Section 3.3.2.2). ▶ If a variable interest holder has decision-making rights or substantive participating rights other than through equity at risk, the holders of the equity at risk collectively lack power; the legal entity is a VIE.
Step 4: Can a single holder of equity at risk (including its related parties and de facto agents) exercise substantive kick-out rights?	▶ If a single holder of equity at risk (including its related parties and de facto agents) can exercise substantive kick-out rights (see Section 3.3.2.2), the legal entity does not have the power characteristic of a VIE. Determine whether the legal entity has other VIE characteristics.

PARTICIPATING RIGHT HELD BY A PARTY THAT DOES NOT HAVE EQUITY AT RISK

If a party holds substantive participating rights other than through equity at risk, the legal entity is a VIE.

3.3.2.1 Identifying a Separate Single Decision Maker and the Significant Activities

FASB REFERENCES

ASC 810-10-15-14(b)(1), ASC 810-10-20: Decision Maker and Decision-Making Authority

When evaluating whether a corporation has the power characteristic of a VIE, once a reporting entity analyzes the nature of the risks in the legal entity (see Section 2.2.1) and determines the legal entity's purpose and the variability it was designed to create and pass along to its interest holders (see Section 2.2.2), the reporting entity determines which activities most significantly impact the legal entity's economic performance. A party with decision-making authority over those activities is a decision maker.

A legal entity generally has many activities, but only a subset of these activities most significantly impacts the legal entity's economic performance. To identify such activities, a reporting entity considers which activities most significantly impact the legal entity's revenues, expenses, operating margins, cash flows, and other key performance indicators. However, the fair value of the legal entity's assets may also be affected by changes in expected future cash flows that are not reflected in the legal entity's financial statements. Those changes must also be considered when identifying the activities that most significantly impact a legal entity's economic performance. For example, a legal entity's purpose may be to develop an intangible asset (such as a new drug, software, or technology). The fair value of that intangible asset is often not reflected in the U.S. GAAP financial statements, but changes in that intangible asset's fair value would significantly impact the legal entity's economic performance. Therefore, developing that intangible asset would be a significant activity of the legal entity.

The right to make a decision that arises only in exceptional circumstances (outside the legal entity's purpose and design) does not affect whether a legal entity is a VIE. Identifying the activities that most significantly impact a legal entity's economic performance requires the application of professional judgment based on the facts and circumstances. The following activities may significantly impact a legal entity's economic performance if such activities are expected as part of the legal entity's purpose and design (this list is illustrative, not determinative).

Approving operating and capital expenditure budgets	Hiring, firing, and compensating management
Financing activities, such as incurring indebtedness, issuing equity, and paying distributions and dividends	Establishing investment strategies and buying or selling investments or other financial assets
Buying or selling significant assets; executing leases; managing credit risk; maintaining assets; and making capital expenditures	Manufacturing, distributing, and selling products, including executing supplier contracts; pricing; and setting sales strategies
R&D for new drug candidates, products, or technologies; buying or developing media content	Servicing and making decisions about delinquent or defaulted financial assets
Extending loans or credit, writing insurance policies, and establishing credit or risk management policies	Executing provider and payor contracts, setting patient care policies, and providing patient care

The right to direct administrative functions, such as accounting or tax matters, are **not** activities that most significantly impact a legal entity's economic performance.

CONSIDERING THE LEGAL ENTITY'S PURPOSE AND DESIGN IS IMPORTANT

While the activities above often are the activities that most significantly impact a legal entity's economic performance (depending on the industry), the significant activities for a specific legal entity depend on its purpose and design.

BDO INSIGHTS — DETERMINING WHETHER A PARTY IS A DECISION MAKER

When decision-making is delegated to a party through an agreement other than equity at risk, the reporting entity must determine whether that party is:

- A decision maker (as defined in ASC 810: "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"), in which case, it has power (if it has a variable interest and there are no substantive kick-out rights or participating rights).
- A manager that is merely executing its role within the context of decisions made by others or is performing administrative activities (for example, filing tax returns) is not a decision maker.

Making this determination can be challenging and requires consideration of whether the holders of the equity at risk put in place parameters and monitoring for delegated activities. The scope of such parameters (that is, whether they are broad or narrow, high or low level) and the frequency and consequences of the monitoring may indicate whether the other party is a decision maker or is managing the legal entity within the context of others' decisions.

The scenarios below illustrate these concepts further.

- An equity holder sets investment guidelines for a manager (which has a variable interest) to make investments on the equity holder's behalf. If the guidelines give the manager broad discretion when choosing investments, the manager is a decision maker because it has the right to make the decisions about the activities that most significantly impact the legal entity's economic performance (the SEC staff discussed this in a speech).
- The holders of the equity at risk establish a detailed operating budget for a manager (which has a variable interest). If the detailed budget and other facts and circumstances constrain the manager's decisions and activities, the manager might not be a decision maker because it might not have the right to make the decisions about the activities that most significantly impact the legal entity's economic performance.

Reaching a conclusion about whether a party is a decision maker requires the application of professional judgment.

SEC STAFF GUIDANCE

Remarks Before the 2019 AICPA Conference on Current SEC and PCAOB Developments

Aaron Shaw, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *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.

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. [Footnotes omitted.]

3.3.2.1.1 Legal Entities With Limited Ongoing Decision-making (Autopilot)

A legal entity may be designed so that limited decisions will occur after its formation. Such legal entities are sometimes referred to as "running on autopilot." When **no** significant decisions will be made after forming a legal entity, power generally is presumed to be held by the parties that participated in the decision-making at formation. However, if **any** decisions after the legal entity's formation could significantly impact the legal entity's economic performance, the party (or parties) making those decisions may have power (even if the scope of those decisions is limited or narrow compared to the scope of decision-making for other legal entities).

BE SKEPTICAL WHEN A LEGAL ENTITY IS SAID TO BE ON AUTOPILOT

We believe a legal entity generally has activities after its formation that most significantly impact its economic performance, and is rarely on autopilot. Identifying the activities that most significantly impact a legal entity's economic performance requires the application of professional judgment based on the facts and circumstances.

Example 3-13 illustrates a legal entity that has limited ongoing decision-making after inception.

EXAMPLE 3-13: LEGAL ENTITY WITH LIMITED ONGOING DECISION-MAKING

FACTS

- A legal entity that is a corporation was formed and financed only with equity.
- It used the proceeds to buy commercial mortgage loans that it will hold until maturity.
- The transaction was marketed to potential investors as an investment in a portfolio of commercial mortgage loans with exposure to credit risk from potential defaults by the borrowers.

- The legal entity is not designed to have operations other than collecting principal and interest and managing defaults and delinquencies; it is not designed to buy or sell loans after formation.

CONCLUSION

The legal entity has activities after formation that most significantly impact its economic performance, so it is not on autopilot.

ANALYSIS

- The legal entity was designed to create and pass along credit risk from mortgage loans to the equity investors. Therefore, managing defaults and delinquencies to maximize collections and the return to equity investors is the activity that most significantly impacts the legal entity's economic performance.
- While the scope of decisions after formation is much more limited than in many other legal entities, managing defaults and delinquencies significantly impacts the legal entity's economic performance after formation.

3.3.2.2 Kick-out Rights When Evaluating a Corporation

FASB REFERENCES

ASC 810-10-15-14(b)(1)(i)(01), ASC 810-10-20: Kick-out Rights (VIE Definition), With Cause, Without Cause

When the legal entity is a corporation, the evaluation of whether the holders of the equity at risk collectively lack power focuses on whether the voting rights or similar rights allow the holders of the equity at risk to direct the activities that most significantly impact the legal entity's economic performance. When a party has the right to make these decisions through a variable interest other than equity at risk, but the holders of the equity at risk collectively have substantive kick-out rights, the legal entity is not a VIE under the power characteristic.

When making this assessment for a corporation, the VIE definition of kick-out rights is used, which is "*the ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE's economic performance or to dissolve (liquidate) the VIE without cause*." Kick-out rights must be substantive (see Section 3.3.4.1) and exercisable without cause to be considered in the evaluation.

Without cause	Without cause means that no reason need be given for the dissolution (liquidation) of the corporation or removal of the decision maker.
With cause	With cause generally restricts the holder's ability to dissolve (liquidate) the corporation or remove the decision maker in situations that include, but that are not limited to, fraud, illegal acts, gross negligence, and bankruptcy of the decision maker.

Rights to liquidate or dissolve the corporation collectively are referred to as liquidation rights. As discussed in paragraph BC49 of ASU 2015-02, a reporting entity treats liquidation rights like kick-out rights if the holder(s) have the substantive right to liquidate a corporation without cause.

See Examples 3-17, 3-18, and 3-21 for illustrations of a decision maker subject to a kick-out right.

3.3.2.3 Participating Rights When Evaluating a Corporation

FASB REFERENCES

ASC 810-10-15-14(b)(1)(i)(01), ASC 810-10-20: Participating Rights (VIE Definition), Protective Rights (VIE definition), and ASC 810-10-25-13

When the legal entity is a corporation, the evaluation of whether the holders of the equity at risk collectively lack power focuses on whether the voting rights or similar rights allow the holders of the equity at risk to direct the activities that most significantly impact the legal entity's economic performance. When a variable interest holder other than a holder of equity at risk has the substantive right to participate in making (or vetoing) these decisions, it prevents the holders of the equity at risk from collectively having power. The VIE definition of participating rights is used to make this assessment for a corporation.

VARIABLE INTEREST ENTITY DEFINITION

Participating Rights

The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Participating rights must be substantive (see Section 3.3.4.2) to be considered when determining whether the holders of the equity at risk collectively lack power. Correctly discerning between participating and protective rights is important because protective rights do not affect whether the holders of the equity at risk lack power.

VIE DEFINITION AND INTERPRETIVE GUIDANCE

Protective rights

Protective rights are rights that do **not** give the holder rights to participate in decision-making for the activities that most significantly impact a legal entity's economic performance. Protective rights may apply only in exceptional circumstances and may include rights to:

- Approve or veto fundamental changes in the activities of a legal entity, such as:
  - Amending the legal entity's governing documents
  - Selling substantially all the legal entity's assets
  - Undertaking activities that change the legal entity's credit risk
  - Removing the decision maker upon bankruptcy or breach of contract
  - Liquidating the legal entity or causing the legal entity to enter bankruptcy
- Approve or veto administrative decisions, such as:
  - Selecting the location of the legal entity's headquarters or the legal entity's name
  - Selecting the legal entity's auditor or accounting policies
  - Restricting specific activities of a franchisee to preserve the franchisor's brand
- Approve or veto self-dealing (related party) transactions, such as:
  - Pricing on transactions between a majority owner and the legal entity
  - Entering contracts between the legal entity and the decision maker's related parties

Such rights are designed to protect the holder's interests and do not affect whether the holders of the equity at risk collectively lack power.

CONSIDER THE LEGAL ENTITY'S PURPOSE AND DESIGN WHEN EVALUATING RIGHTS

Determining whether a right is participating or protective requires understanding the legal entity's purpose and design (see Section 2.2.2.2), identifying the activities that most significantly impact the legal entity's economic performance (see Section 3.3.2.1), and appying professional judgment based on the facts and circumstances.

For example, decisions about capital expenditures may significantly impact the economic performance of a capital-intensive business (for example, a manufacturing business); if so, a right to approve or veto capital expenditures would be a participating right for that legal entity. In contrast, decisions about capital expenditures may not significantly impact the economic performance of a service-based business (for example, asset management); such a right might be protective for that legal entity.

When a party has the right to veto or block actions (for example, capital expenditures) above a threshold, the reporting entity must evaluate whether such action is expected to significantly impact the legal entity's economic performance (based on the legal entity's purpose and design). A veto right with a low threshold is more likely to be a participating right than a veto right with a high threshold. However, determining what constitutes a low or high threshold is a matter of judgment based on the legal entity's purpose and design.

If parties without equity at risk have substantive participating rights, the holders of the equity at risk collectively lack power and the legal entity is a VIE.

Example 3-14 illustrates the assessment when a substantive participating right is held other than through equity at risk.

EXAMPLE 3-14: SUBSTANTIVE PARTICIPATING RIGHT HELD BY INVESTOR THAT DOES NOT HAVE EQUITY AT RISK

FACTS

- Investors A and Investor B formed a corporation. Investor A has equity at risk but Investor B does not.
- The corporation is designed to create and pass along operations risk to its interest holders.
- Investor A has the contractual right to propose the annual budget, which is an activity that most significantly impacts the corporation's economic performance.
- Investor B has a substantive veto right over that operating budget (for example, neither party has the right to break the tie; see Section 3.3.4.2 for guidance on evaluating whether a participating right is substantive).

CONCLUSION

The holders of the equity at risk collectively lack the power to direct the activities that most significantly impact the corporation's economic performance. Therefore, the corporation is a VIE.

ANALYSIS

- Step 1: Is there a separate decision maker (other than through equity at risk)?
  - No. The corporation was designed to create and pass along operations risk to its interest holders. Approving the operating budget is an activity that most significantly impacts the corporation's economic performance. Neither Investor A nor Investor B makes decisions about the operating budget through a variable interest other than equity at risk (for example, by contract), so there is not a separate decision maker.
- Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?
  - No. Investor B does not have equity at risk but does have a substantive veto right over approving the operating budget, which is an activity that most significantly impacts the corporation's economic performance, so the holders of the equity at risk collectively lack power. Therefore, the corporation is a VIE.

3.3.2.4 Examples of Evaluating the Power Characteristic for a Corporation

FASB REFERENCES

ASC 810-10-15-14(b)(1)(i), ASC 810-10-55-8A through 8H, ASC 810-10-55-122 through 55-133, ASC 810-10-55-172 through 55-181, and ASC 810-10-55-205Z through 55-205AI

Examples 3-15 through 3-22 illustrate the evaluation of the power characteristic for a corporation. Each example is written within the context of a particular industry to illustrate how a reporting entity might evaluate the legal entity's purpose and design and identify the activities that most significantly impact the legal entity's economic performance. The examples are not meant to be determinative.

DESCRIPTION	EXAMPLE
Manager has administrative rights (life sciences entity)	Example 3-15
Decision maker does not have a variable interest (life sciences entity)	Example 3-16
Decision maker has a variable interest (real estate entity)	Example 3-17
Decision maker has a variable interest (series fund)	Example 3-18
Decision maker has a variable interest (structured investment vehicle)	Example 3-19
Decision maker has a variable interest (property lessor)	Example 3-20
Decision maker has a variable interest (online distribution entity)	Example 3-21
One holder of equity at risk does not participate (technology entity)	Example 3-22

EXAMPLE 3-15: POWER ASSESSMENT FOR A CORPORATION — MANAGER HAS ADMINISTRATIVE RIGHTS (LIFE SCIENCES ENTITY)

FACTS

- Investor A (the reporting entity) and Investor B formed a corporation (the legal entity) to research and develop and market several drug candidates.
- Investor A and Investor B paid cash in exchange for 60% and 40%, respectively, of the corporation's equity, which is at risk (see Section 3.2.2).
- Investor A and Investor B collectively appoint the corporation's board of directors. The board makes decisions about the activities that most significantly impact the corporation's economic performance, which are decisions about R&D for the drug candidates, approving the operating budget, marketing approved drug candidates, and entering collaboration agreements.
- The articles of incorporation specify that the board of directors has authority over the corporation's business.

- Pursuant to this authority, the board directed the corporation to enter a 10-year management agreement with Investor B (as manager) in exchange for annual fees that are customary and commensurate and that do not expose Investor B to risk of loss.
  - The management services include enforcing the corporation's contracts, preparing financial reports, and overseeing the corporation's compliance with regulatory requirements.
  - The fees are variable interests because Investor B has other interests (its 40% equity interest) that would absorb more than an insignificant amount of the corporation's expected variability (see Section 2.3.8).
  - The board cannot terminate the agreement without cause.

CONCLUSION

The holders of the equity at risk collectively have the power to direct the activities that most significantly impact the corporation's economic performance. Investor A must determine whether the corporation has any other VIE characteristics.

ANALYSIS

- Step 1: Is there a separate decision maker (other than through equity at risk)?
  - No. The corporation was designed to create and pass along operations risk (from R&D for drug candidates and marketing several drug candidates) to its interest holders. The activities that most significantly impact the corporation's economic performance are decisions about R&D, approving the operating budget, marketing approved drug candidates, and entering collaboration agreements.
  - Investor B's rights (as manager) relate to administrative matters, such as enforcing contracts, preparing financial reports, and complying with regulatory requirements. Such decisions do not relate to activities that most significantly impact the corporation's economic performance, so Investor B is not a separate decision maker.
- Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?
  - Yes. The board makes all decisions about the activities that most significantly impact the corporation's economic performance. Only holders of equity at risk (Investors A and B) appoint the board. Therefore, the holders of the equity at risk collectively have power.

EXAMPLE 3-16: POWER ASSESSMENT FOR A CORPORATION — DECISION MAKER DOES NOT HAVE A VARIABLE INTEREST (LIFE SCIENCES ENTITY)

FACTS

Assume the same facts as in Example 3-15, except:

- The board directed the corporation to enter a 10-year management agreement with a third-party manager in exchange for annual fees that are customary and commensurate and that do not expose the manager to risk of loss. The manager does not hold equity.
- The manager makes all decisions about the activities that most significantly impact the corporation's economic performance, which are decisions about R&D, approving the operating budget, marketing approved drug candidates, and entering collaboration agreements. The board cannot terminate the agreement without cause.

CONCLUSION

The holders of the equity at risk collectively have the power to direct the activities that most significantly impact the corporation's economic performance. Investor A must determine whether the corporation has any other VIE characteristics.

ANALYSIS

- Step 1: Is there a separate decision maker (other than through equity at risk)?
  - Yes. The corporation was designed to create and pass along operations risk (from R&D and marketing several drug candidates) to its interest holders. The activities that most significantly impact the corporation's economic performance are decisions about R&D, approving the operating budget, marketing approved drug candidates, and entering collaboration agreements. The manager has decision-making rights over those activities through a contract other than equity at risk, so it is a separate decision maker.
- Step 2: Does the separate decision maker hold a variable interest?
  - No. The manager does not have a variable interest in the corporation and therefore is presumed to be acting as an agent on behalf of the holders of the equity at risk, that is, on behalf of Investors A and B (see Section 3.3.2). The fees are not variable interests because they are customary and commensurate, the manager does not have other interests that would absorb more than an insignificant amount of the corporation's expected variability, and the manager is not exposed to risk of loss (see Section 2.3.8). Therefore, the decision-making rights held by the manager do not prevent the holders of the equity at risk collectively from having power, so the holders of the equity at risk collectively have power.

EXAMPLE 3-17: POWER ASSESSMENT FOR A CORPORATION — DECISION MAKER HAS A VARIABLE INTEREST (REAL ESTATE ENTITY)

FACTS

- A real estate company and an asset management company (the manager) formed a corporation (the legal entity) to acquire and operate senior living facilities.
- The real estate company and the manager paid cash in exchange for 40% and 60%, respectively, of the corporation's equity, which is at risk (see Section 3.2.2).
- Collectively, the equity investors appoint the board members.
- The articles of incorporation specify that the board of directors has authority over the corporation's business.
- Pursuant to this authority, the board directed the corporation to enter a 10-year management agreement with the manager in exchange for annual fees that are customary and commensurate and that do not expose the manager to risk of loss. The board cannot terminate the agreement without cause (see Section 3.3.2.2).
- The manager can transfer its equity interest in the corporation without also transferring its rights under the agreement and vice versa. In other words, the manager could remain as the corporation's manager under the agreement even if it sold its 60% equity interest in the corporation.

The following table lists the activities that most significantly impact the corporation's economic performance and which party makes decisions about such activities.

SIGNIFICANT ACTIVITIES AND HOW DECISIONS ARE MADE	BOARD	MANAGER
Operating the facilities pursuant to an operating budget set solely by the manager		✓
Acquiring new facilities	✓	✓
Approving capital budgets	✓	✓

CONCLUSION

The holders of the equity at risk collectively lack the power to direct the activities that most significantly impact the corporation's economic performance. Therefore, the corporation is a VIE.

ANALYSIS

- Step 1: Is there a separate decision maker (other than through equity at risk)?
  - Yes. The corporation was designed to create and pass along operations risk (from acquiring and operating senior living facilities) to its interest holders. The manager has decision-making rights over operating the senior living facilities pursuant to a budget that it sets, which is one of the activities that most significantly impacts the corporation's economic performance. The manager has decision-making rights over that activity through a contract other than equity at risk, so it is a separate decision maker.
- Step 2: Does the separate decision maker hold a variable interest?
  - Yes. The manager's fees are customary and commensurate and do not expose the manager to risk of loss. However, the manager has other interests (its 60% equity interest) that would absorb more than an insignificant amount of the corporation's expected variability (see Section 2.3.8). Therefore, the fees are variable interests.
- Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?
  - No. While the manager also holds equity at risk in the corporation, its decision-making rights over the activities that most significantly impact the corporation's economic performance stem from a management agreement, not from its equity at risk. The board cannot terminate the agreement without cause.
- Step 4: Can a single holder of equity at risk (including its related parties and de facto agents) exercise substantive kick-out rights?
  - No. The holders of the equity at risk do not have substantive kick-out rights for the reasons described in Step 3. Therefore, the holders of the equity at risk collectively lack power.

Mutual funds commonly operate as a series company or series fund in which a single corporation or trust is set up using one organizational document with one board of directors or trustees (generally referred to as an "umbrella trust"). The umbrella trust has several series funds, each with separate investment objectives, asset managers, policies, and shareholders from the other series (see Section 1.2.2). Example 3-18 illustrates the assessment of whether the holders of the equity at risk collectively lack power for a series fund.

EXAMPLE 3-18 (ADAPTED FROM ASC 810-10-55-8A THROUGH 55-8H): POWER ASSESSMENT FOR A CORPORATION — DECISION MAKER HAS A VARIABLE INTEREST (SERIES FUND)

FACTS

- An asset manager formed and registered a series of mutual funds (Fund A, Fund B, and Fund C) using one (umbrella) trust. Each mutual (or series) fund must comply with the 1940 Act and is considered a separate legal entity (see Section 1.2.2).
- There is a single board of trustees for the entire umbrella trust. A simple majority of all shareholders of all the series funds (Fund A, Fund B, and Fund C) must collectively vote to remove and replace the board.
- The purpose, objective, and investment strategy of each series fund was set at formation and agreed on by its respective shareholders. Returns of each series fund are distributed only to that fund's shareholders. There is no cross-collateralization between the funds.
- Each series fund has its own fund management team employed by the asset manager to manage the investments in accordance with that fund's investment strategy. The asset manager is compensated with fees that are customary and commensurate, and it is not exposed to risk of loss (see Section 2.3.8).
- The asset manager sold 65% of Fund A's shares to external shareholders and kept the remaining 35%. The equity of each series fund is equity at risk (see Section 3.2.2). The asset manager does not have interests in Fund B or Fund C (the shares were sold to external shareholders).
- A simple majority vote of the shareholders in each series fund is required to make decisions about:

- Removing and replacing the asset manager without cause (for example, a simple majority of only Fund A's shareholders can vote to remove and replace Fund A's asset manager)
- Compensating the asset manager
- Changing the fund's investment strategy
- Selling substantially all the fund's assets
- Approving the fund's merger or reorganization
- Liquidating or dissolving the fund
- Amending the bylaws and charter
- Increasing the authorized shares

CONCLUSION

The holders of the equity at risk for Fund A, Fund B, and Fund C collectively have the power to direct the activities that most significantly impact their respective fund's economic performance. The reporting entity must determine whether each series fund has other VIE characteristics.

ANALYSIS

- Step 1: Is there a separate decision maker (other than through equity at risk)?
  - Yes. Each fund was designed to create and pass along equity price risk (earn a return) on the investments in that fund to its respective interest holders. The investing activities most significantly impact each series fund's economic performance. Each asset manager has decision-making rights over those activities through a management contract other than equity at risk, so each asset manager is a separate decision maker for that respective fund.
- Step 2: Does the separate decision maker hold a variable interest?
  - No, not for Fund B or Fund C. The asset managers for Fund B and Fund C each receive fees that are customary and commensurate, have no other interests in those funds, and are not exposed to risk of loss. Accordingly, the asset managers' fees for Fund B and Fund C are not variable interests, and the asset managers are presumed to be acting as agents (see Section 3.3.2) on behalf of the holders of the equity at risk. Therefore, the decision-making rights held by the asset managers do not prevent the holders of the equity at risk from having power over Fund B and Fund C, so the holders of the equity at risk collectively have power over Fund B and Fund C.
  - Yes, for Fund A. The fees are customary and commensurate and do not expose Fund A's asset manager to risk of loss. However, the fees are variable interests because Fund A's asset manager has a 35% equity interest, which would absorb more than an insignificant amount of Fund A's expected variability (see Section 2.3.8).
- Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?
  - Yes. Fund A's shareholders make the decisions about the activities that most significantly impact its economic performance because they have the ability through voting rights to remove and replace Fund A's asset manager without cause, approve the asset manager's compensation, and vote on Fund A's investment strategy. Therefore, the holders of the equity at risk for Fund A collectively have power.
  - It is irrelevant that shareholders of each series fund lack the rights at the series-level to remove and replace the board (that is, it is irrelevant that a majority of the shareholders of all the funds in the aggregate must vote to exercise that right) because the board does not make the decisions about the activities that most significantly impact the funds' economic performance.

EXAMPLE 3-19 (ADAPTED FROM ASC 810-10-55-122 THROUGH 55-133): POWER ASSESSMENT FOR A CORPORATION — DECISION MAKER HAS A VARIABLE INTEREST (STRUCTURED INVESTMENT VEHICLE)

FACTS

- A sponsor formed a corporation (the legal entity) that was financed with $94 million of AAA-rated fixed-rate, short-term debt and $6 million of equity. Third-party investors hold the short-term debt and equity. Upon maturity, the corporation will refinance the short-term debt at market rates.
- The corporation used the proceeds to buy 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 corporation's purpose is to maximize the spread between returns on its asset portfolio and its weighted-average cost of funding. The sponsor marketed the transaction to potential debt investors as an investment in a portfolio of high-quality debt with exposure to credit risk from potential defaults on debt in the portfolio. The equity absorbs the first-dollar risk of loss; is exposed to liquidity risk (because the average tenor of the corporation's assets is greater than its liabilities); and absorbs expected residual returns from favorable changes related to credit, liquidity, fair value, and interest rates.
- The sponsor manages:
  - Investing activities — Debt investments must comply with the corporation's established investment guidelines, including eligible investments, country risk exposures, diversification, and ratings.
  - Funding activities — The corporation's debt is managed (including refinancing short-term debt upon maturity) to minimize the cost of borrowing, interest rate risks, and liquidity risks, and to meet capital requirements.
  - Defeasance activities — If the corporation's debt ratings fall below a specified level, the sponsor oversees the investment portfolio's liquidation and discharges the corporation's obligations.
- The sponsor receives fees that are customary and commensurate and cannot be removed without cause. Although the fee arrangement does not explicitly expose the sponsor to risk of loss, the sponsor determined that it has an implicit variable interest in the corporation because it is implicitly obligated to absorb expected losses that could potentially be significant to the corporation to protect its own reputation if the corporation does not operate as designed (see Sections 2.3.8 and 2.6).
- The debt holders have no voting rights. The equity holders have rights to veto amendments to the corporation's governing documents.

CONCLUSION

The holders of the equity at risk collectively lack the power to direct the activities that most significantly impact the corporation's economic performance. Therefore, the corporation is a VIE. See Example 4-22 for the identification of its primary beneficiary.

ANALYSIS

- Step 1: Is there a separate decision maker (other than through equity at risk)?
  - Yes. The corporation was designed to create and pass along credit, interest rate, and liquidity risk to its interest holders. The activities that most significantly impact the corporation's economic performance are managing the investing, funding, and defeasance activities. The sponsor has decision-making rights over those activities through a contract other than equity at risk, so it is a separate decision maker.
- Step 2: Does the separate decision maker hold a variable interest?
  - Yes. The sponsor's fees are customary and commensurate. However, the sponsor's implicit variable interest is an other interest that causes the fees to be variable interests (see Section 2.3.8). The implicit interest also is a variable interest.
- Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?
  - No. The sponsor makes the decisions about the activities that most significantly impact the corporation's economic performance and cannot be removed without cause. The equity holders' right to veto amendments

to the governing documents is a protective right because it relates to a fundamental change in the corporation's activities and is designed only to protect the equity holders' interests (see Section 3.3.2.3).

- Step 4: Can a single holder of equity at risk (including its related parties and de facto agents) exercise substantive kick-out rights?
  - No. The holders of the equity at risk do not have substantive kick-out rights for the reasons described in Step 3. Therefore, they collectively lack power.

EXAMPLE 3-20 (ADAPTED FROM ASC 810-10-55-78 THROUGH 55-80 AND ASC 810-10-55-172 THROUGH 55-181): POWER ASSESSMENT FOR A CORPORATION — DECISION MAKER HAS A VARIABLE INTEREST (PROPERTY LESSOR)

FACTS

- A corporation (the legal entity) was formed and financed with $95 million of fixed-rate debt that matures in five years and $5 million of equity. It used the proceeds to buy a property, which it leased to a lessee with an AA credit rating.
- The lease has a five-year term and cannot be unilaterally terminated by either party.
- The lessee guaranteed the property's residual value at the end of five years and has a fixed-price purchase option to buy the property for the same amount (the option price). If the lessee does not exercise the option at the end of the lease term, it must resell the property on the lessor legal entity's behalf.
  - If the property sells for less than the option price, the lessee must pay the lessor legal entity the difference between the option price and the sales proceeds up to a specified percentage of the option price.
  - If the property sells for more than the option price, the lessee keeps the excess.
- A third party provided a small additional residual value guarantee to the lessor legal entity.
- The lessor legal entity cannot buy other assets or sell the property for five years. It was designed so the lessee has the right to use the property through an operating lease and to keep substantially all the risks and rewards from changes in the property value.
- The lessee directs maintenance and operations of the leased property (which affect the property's fair value), as well as selling the property if it does not exercise its purchase option, which are the activities that most significantly impact the lessor legal entity's economic performance. The equity investors have only protective rights.
- The debt was marketed to potential debt investors as a fixed-rate investment in an AA-rated asset collateralized by the property.
- The lease is classified as a direct financing lease by the lessor legal entity and as an operating lease by the lessee.

CONCLUSION

The holders of the equity at risk collectively lack the power to direct the activities that most significantly impact the lessor legal entity's economic performance. Therefore, the lessor legal entity is a VIE. See Example 4-26 for the identification of its primary beneficiary.

ANALYSIS

- Step 1: Is there a separate decision maker (other than through equity at risk)?
  - Yes. The lessor legal entity was designed to create and pass along changes in the property's fair value at the end of five years and credit risk from a potential default by the lessee to its interest holders. The lessor legal entity's purpose and design is to give the lessee use of the property for five years and pass along substantially all the rights and obligations of ownership, including tax benefits, to the lessee. (See Example 2-7 for more discussion about the lessor legal entity's purpose and design.) The activities that most significantly impact the lessor legal entity's economic performance are maintenance and operations of the leased property (which

affects the property's fair value), as well as selling the property if the lessee does not exercise the purchase option. The lessee has decision-making rights over those activities through a contract other than equity at risk, so it is a separate decision maker.

- Step 2: Does the separate decision maker hold a variable interest?
  - Yes. The lessee has a variable interest in the lessor legal entity as a whole because it has a residual value guarantee and a fixed-price purchase option, and the property to which those interests relate is 100% of the fair value of the lessor legal entity's assets (see Sections 2.3.6 and 2.4 and Example 2-7).
- Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?
  - No. The lessee makes the decisions about the activities that most significantly impact the lessor legal entity's economic performance through its lease. The holders of the equity at risk cannot remove the lessee or unilaterally terminate the lease (which would effectively kick-out the lessee) and do not have participating rights (they hold only protective rights).
- Step 4: Can a single holder of equity at risk (including its related parties and de facto agents) exercise substantive kick-out rights?
  - No. The holders at risk do not have substantive kick-out rights for the reasons described in Step 3.

During the 2019 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff discussed another fact pattern involving a lessor legal entity.

EXAMPLE 3-21 (ADAPTED FROM ASC 810-10-55-205Z THROUGH 55-205AI): POWER ASSESSMENT FOR A CORPORATION — DECISION MAKER HAS A VARIABLE INTEREST (ONLINE DISTRIBUTION ENTITY)

FACTS

- Investor A formed a corporation (the legal entity) to which it exclusively licensed intellectual property to operate in a new country.
- The equity holders have voting rights only on administrative matters (that is, they hold only protective rights). The country where the corporation is domiciled prohibits foreign investment through equity (Investor A cannot directly own the corporation's equity).
- The license agreement gives Investor A the right to make all strategic and technical decisions for the corporation. For these services, Investor A receives fees that are not customary and commensurate and that give it the right to receive benefits from the corporation that would potentially be significant to the corporation. The license agreement cannot be terminated without cause.

CONCLUSION

The holders of the equity at risk collectively lack the power to direct the activities that most significantly impact the corporation's economic performance. Therefore, the corporation is a VIE. See Example 4-29 for the identification of its primary beneficiary.

ANALYSIS

- Step 1: Is there a separate decision maker (other than through equity at risk)?
  - Yes. The corporation was designed to create and pass along operations risk (benefiting from using the intellectual property) to its interest holders. The corporation's purpose and design is to enable Investor A to bypass foreign investment restrictions through a contractual arrangement to use the intellectual property to operate in a new country. The activities that most significantly impact the corporation's economic performance are making strategic and technical decisions for the corporation. Investor A has decision-making rights over those activities through a contract other than equity at risk, so it is a separate decision maker.
- Step 2: Does the separate decision maker hold a variable interest?
  - Yes. Investor A's fees are not customary and commensurate, so they are variable interests.
- Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?

- No. Investor A makes all strategic and technical decisions for the corporation, which are the activities that most significantly impact the corporation's economic performance. The holders of the equity at risk do not have rights to direct the activities that most significantly impact the corporation's economic performance and cannot terminate the license agreement without cause.

- Step 4: Can a single holder of equity at risk (including its related parties and de facto agents) exercise substantive kick-out rights?
  - No. The holders of the equity at risk do not have substantive kick-out rights for the reasons discussed in Step 3. Therefore, they collectively lack power.

EXAMPLE 3-22: POWER ASSESSMENT FOR A CORPORATION — ONE HOLDER OF EQUITY AT RISK DOES NOT PARTICIPATE (TECHNOLOGY ENTITY)

FACTS

- Investors A, B, and C formed a corporation (the legal entity) to develop and market a new technology.
- Investor A, B, and C paid cash in exchange for 45%, 40%, and 15%, respectively, of the corporation's equity, which is at risk (see Section 3.2.2).
- In accordance with the corporation's governing documents, the board has three directors: one appointed by Investor A, one by Investor B, and one jointly agreed by Investor A and Investor B. Investor C does not have board representation.
- The articles of incorporation specify that the board of directors has the right to direct all activities that significantly impact the corporation's economic performance, which are decisions about developing and marketing the new technology.

CONCLUSION

The holders of the equity at risk collectively have the power to direct the activities that most significantly impact the corporation's economic performance. The reporting entity must determine whether the corporation has any other VIE characteristics.

ANALYSIS

- Step 1: Is there a separate decision maker (other than through equity at risk)?
  - No. The corporation was designed to create and pass along operations risk (related to developing a new technology) to its interest holders. The activities that most significantly impact the corporation's economic performance are developing and marketing the new technology. The board, which is appointed by the holders of the equity at risk, has decision-making rights over those activities, so there is not a separate decision maker.
- Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?
  - Yes. The holders of the equity at risk collectively have the power to direct the activities that most significantly impact the corporation's economic performance because the board (which is appointed by the holders of the equity at risk) makes all decisions. All the holders of the equity at risk do not need to have the right to direct the activities that most significantly impact the corporation's economic performance if **only** the holders of the equity at risk collectively have that right. Investor C's lack of board representation does not cause the corporation to be a VIE. Therefore, the holders of the equity at risk collectively have power.

3.3.3 Evaluating Limited Partnerships and Similar Entities

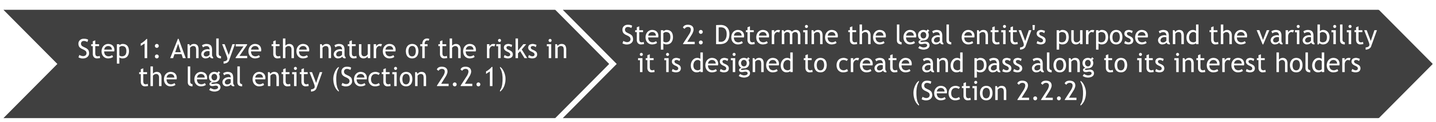
FASB REFERENCES

ASC 810-10-15-14(b)(1)(ii), ASC 810-10-45-14, ASC 910-810-45-1, and ASC 932-810-45-1

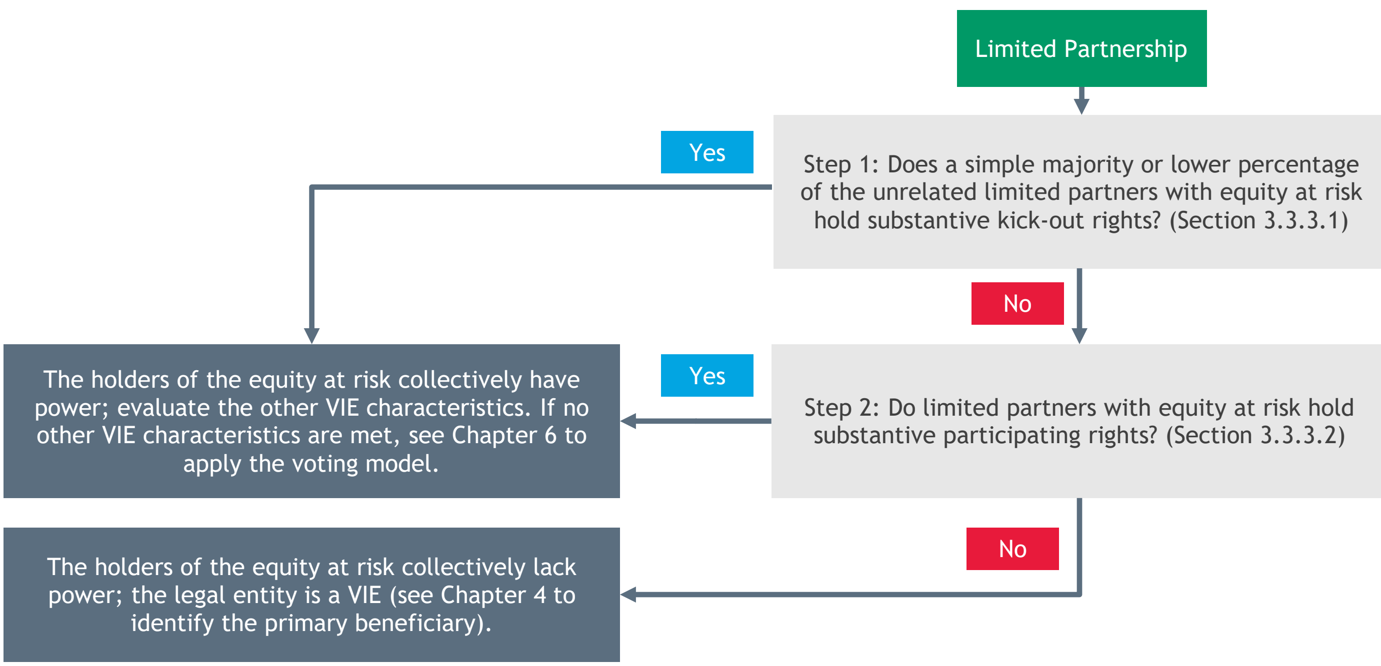
When the legal entity is a limited partnership, the evaluation of whether the holders of the equity at risk collectively lack power focuses on whether the limited partners with equity at risk have the right to remove the general partner (that is, kick-out rights, see Section 3.3.3.1) or have rights to participate in the limited partnership's significant operating and financial policies in the ordinary course of business (that is, participating rights, see Section 3.3.3.2).

The premise underlying this evaluation is that a general partner usually has the right to make a limited partnership's significant financial and operating decisions, subject to any kick-out rights or participating rights held by the limited partners, as stated in the partnership agreement.

Therefore, to identify the limited partnership's significant financial and operating decisions and determine whether the limited partners with equity at risk collectively lack power, the facts and circumstances are evaluated, as follows:



This information is then used to determine whether the limited partners with equity at risk collectively lack power.



Kick-out rights and participating rights must be substantive for the limited partners with equity at risk to collectively have power (that is, for the limited partnership not to be a VIE under the power characteristic). To be substantive, no significant barriers can prevent the limited partners from exercising such rights (see Section 3.3.4).

Determining whether the limited partners with equity at risk collectively lack power requires the application of professional judgment based on the facts and circumstances. See Section 3.3.3.3 for examples illustrating these steps.

CONSIDER SCOPE FOR INDUSTRIES THAT APPLY PROPORTIONATE CONSOLIDATION

The guidance in this section does not apply to limited partnerships in industries in which it is appropriate for a general partner to use proportionate consolidation to account for its investment in a limited partnership (see ASC 910-810-45-1 and ASC 932-810-45-1). Therefore, a limited partnership in the extractive or construction industries that is within the scope of this guidance is not a VIE just because its limited partners with equity at risk lack substantive kick-out rights or participating rights; the limited partnership must be evaluated to determine whether it has any other VIE characteristics.

3.3.3.1 Kick-Out Rights When Evaluating a Limited Partnership

FASB REFERENCES

ASC 810-10-15-14(b)(1)(ii)(01), ASC 810-10-20: Kick-Out Rights (Voting Interest Entity Definition), With Cause, Without Cause, ASC 810-10-25-14B, and ASC 810-10-55-4N through 55-4W

When the legal entity is a limited partnership, the evaluation of whether the limited partners with equity at risk collectively lack power focuses on whether the limited partners with equity at risk have substantive kick-out rights or participating rights (see Section 3.3.3.2). To make this assessment for a limited partnership, a reporting entity uses the voting interest entity definition of kick-out rights, which is "*the rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.*"

Kick-out rights must be substantive (see Section 3.3.4.1) and exercisable without cause to be considered when determining whether the limited partners with equity at risk collectively lack power.

Without cause	*Without cause means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners.*
With cause	*With cause generally restricts the limited partners' ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that are not limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.*

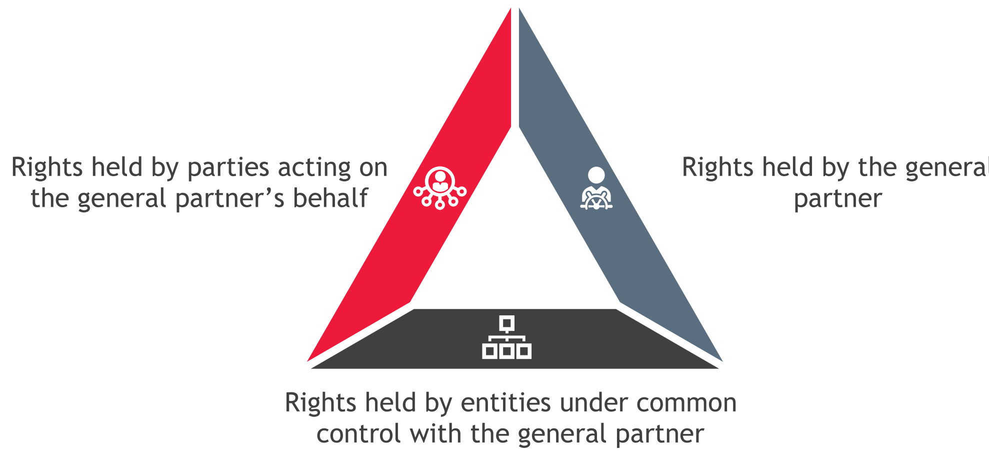
Rights to liquidate or dissolve the limited partnership collectively are referred to as "liquidation rights." As discussed in paragraph BC49 of ASU 2015-02, a reporting entity treats liquidation rights like kick-out rights if the holder(s) have the substantive right to liquidate a limited partnership without cause.

Withdrawal rights allow limited partners to withdraw from a limited partnership.

- A withdrawal right that requires the limited partnership's dissolution or liquidation is evaluated like a kick-out right.
- A withdrawal right that does not require the limited partnership's dissolution or liquidation is not treated like a kick-out right.

Generally, the partnership agreement or state law determines whether such withdrawal causes the limited partnership's dissolution or liquidation. However, other facts and circumstances, such as the number of limited partners and the assets' liquidity, may also affect whether withdrawal rights could cause the limited partnership's dissolution or liquidation. Reaching a conclusion about whether a withdrawal right explicitly or implicitly requires the limited partnership's dissolution or liquidation and whether that right is substantive[10] (see Section 3.3.4.1) requires the application of professional judgment based on the facts and circumstances.

When calculating whether a simple majority or lower threshold of the limited partners with equity at risk have substantive kick-out rights, a reporting entity excludes the following rights:



It is presumed that the parties above would not vote to remove the general partner, making such rights nonsubstantive. Determining whether a party (such as a related party or de facto agent) is acting on the general partner's behalf requires the application of professional judgment based on the facts and circumstances. See Chapter 5 for guidance on identifying related parties and de facto agents.

Examples 3-23 through 3-25 illustrate the assessment of kick-out rights.

EXAMPLE 3-23 (ADAPTED FROM ASC 810-10-55-4N THROUGH 55-4W): LIMITED PARTNER KICK-OUT RIGHTS

FACTS

In each scenario:

- A general partner (GP) and limited partners (LPs) with equity at risk formed a limited partnership (the legal entity).
- The LPs are not under common control with or acting on the GP's behalf.
- The GP makes the limited partnership's significant financial and operating decisions.
- Each LP holds substantive kick-out rights exercisable without cause.
- No LP holds substantive participating rights.

The following table shows the dispersion of kick-out rights, the threshold needed to remove the GP, and the conclusion and analysis under Step 1 in the flowchart in Section 3.3.3. For each scenario in which the LPs with equity at risk collectively have power, the reporting entity must determine whether the limited partnership has any other VIE characteristics.

[10] ASU 2015-02, paragraphs BC53 through BC54.

DISPERSION AND REQUIREMENT FOR REMOVING THE GP	CONCLUSION AND ANALYSIS
Case A1: Three LPs each hold 33.33% of the equity and kick-out rights; a simple majority of the kick-out rights (two of three LPs) is required to remove the GP.	The LPs collectively have power; a two-thirds vote is a simple majority (because any combination of 50% of the LPs can meet the threshold).
Case A2: Three LPs each hold 33.33% of the equity and kick-out rights; a unanimous vote of the LPs is required to remove the GP.	The LPs collectively lack power; unanimity is a higher threshold than a simple majority in this case. Therefore, the limited partnership is a VIE.
Case A3: Three LPs each hold 33.33% of the equity and kick-out rights; only one LP vote to remove the GP is required.	The LPs collectively have power; a substantive kick-out right held by a single LP is a lower threshold than a simple majority of the LPs.
Case B: Two LPs each hold 50% of the equity and kick-out rights; a unanimous vote is required to remove the GP.	The LPs collectively have power; a unanimous vote is the same as a simple majority in this case.
Case C1: 100 LPs each hold 1% of the equity and kick-out rights; a simple majority of the voting interests (in this case, 51 LPs) is required to remove the GP.	The LPs collectively have power; any combination of 51 LPs is a simple majority can remove the GP.
Case C2: 100 LPs each hold 1% of the equity and kick-out rights; 52 LPs must vote to remove the GP.	The LPs collectively lack power; any combination of 52 LPs is more than a simple majority (more than 51%). Therefore, the limited partnership is a VIE.
Case D1: Three LPs each hold 33.33% of the equity and kick-out rights; 66.6% of the vote is required to remove the GP.	The LPs collectively have power; a two-thirds vote of the LPs is 66.6%, which is the same as a simple majority in this case.
Case D2: Three LPs hold 45%, 25%, and 30% of the equity and kick-out rights, respectively; 66.6% of the vote is required to remove the GP.	The LPs collectively lack power; some combinations of LPs that are a simple majority (the LPs that own 25% and 30%) cannot remove the GP. Therefore, the limited partnership is a VIE.
Case E: Four LPs each hold 10% of the equity and 25% of the kick-out rights. The GP owns 60% of the equity but does not have kick-out rights. The four unrelated LPs must vote unanimously to remove the GP.	The LPs collectively lack power; unanimity is a higher threshold than a simple majority in this case. Therefore, the limited partnership is a VIE.
Case F: One LP holds 40% of the equity and 100% of the kick-out rights. The GP owns 60% of the equity but does not have kick-out rights. A simple majority vote of kick-out rights is required to remove the GP.	The LP has power; a substantive kick-out right held by a single LP is a lower threshold than a simple majority.
Case G: Four LPs each hold 10% of the equity and 25% of the kick-out rights. The GP owns 60% of the equity but does not have kick-out rights. A simple majority of the four LPs is required to remove the GP.	The LPs collectively have power; substantive kick-out rights held by a simple majority of the LPs can remove the GP.

EXAMPLE 3-24: KICK-OUT RIGHTS HELD BY PARTIES RELATED TO THE GENERAL PARTNER

FACTS

A general partner and four limited partners with equity at risk formed a limited partnership (the legal entity) with the equity ownership interests and kick-out rights listed in the table.

PARTNER	EQUITY	KICK-OUT RIGHTS	RELATIONSHIP TO THE GENERAL PARTNER
Limited partner A	24%	30%	Not under common control with or acting on the general partner's behalf
Limited partner B	20%	25%	Not under common control with or acting on the general partner's behalf
Limited partner C	24%	30%	Not under common control with or acting on the general partner's behalf
Limited partner D	12%	15%	Under common control with the general partner
General partner	20%	–	
Total	100%	100%	

- The general partner makes the limited partnership's significant financial and operating decisions.
- The partnership agreement requires at least a 50% of the kick-out rights to be exercised to remove the general partner. The kick-out rights are substantive and exercisable without cause.
- No limited partners hold substantive participating rights.

CONCLUSION

The limited partners with equity at risk collectively have power. The reporting entity must determine whether the limited partnership has any other VIE characteristics.

ANALYSIS

- Step 1: Does a simple majority or lower percentage of the unrelated limited partners with equity at risk hold substantive kick-out rights?
  - Yes. Kick-out rights held by the general partner, entities under common control with the general partner, and entities acting on the general partner's behalf are excluded when evaluating whether a simple majority of the limited partners with equity at risk can exercise substantive kick-out rights. Accordingly, the kick-out rights held by limited partner D (15%) are excluded from the analysis. Therefore, when calculating whether a simple majority of the limited partners can remove the general partner, only the remaining 85% of kick-out rights held by the other limited partners are included. Any combination of two of limited partners A, B, and C can remove the general partner (equivalent in this fact pattern to a simple majority). The kick-out rights are substantive (there are no significant barriers to exercise) and exercisable without cause. Therefore, the limited partners with equity at risk collectively have power.

EXAMPLE 3-25: KICK-OUT RIGHTS HELD BY PARTIES RELATED TO THE GENERAL PARTNER

FACTS

A general partner and six limited partners with equity at risk formed a limited partnership (the legal entity) with the equity ownership interests and kick-out rights listed in the table.

PARTNER	EQUITY	KICK-OUT RIGHTS	RELATIONSHIP TO THE GENERAL PARTNER
Limited partners A through E	10% each	12.5% each	Not under common control with or acting on the general partner's behalf
Limited partner F	30%	37.5%	Under common control with the general partner
General partner	20%	–	
Total	100%	100%	

- The general partner makes the limited partnership's significant financial and operating decisions.
- The partnership agreement requires more than 50% of the kick-out rights to remove the general partner. The kick-out rights are exercisable without cause.
- No limited partners hold substantive participating rights.

CONCLUSION

The limited partners with equity at risk collectively lack power. Therefore, the limited partnership is a VIE.

ANALYSIS

- Step 1: Does a simple majority or lower percentage of the unrelated limited partners with equity at risk hold substantive kick-out rights?
  - No. Kick-out rights held by the general partner, entities under common control with the general partner, and entities acting on the general partner's behalf are excluded when evaluating whether a simple majority of the limited partners with equity at risk can exercise substantive kick-out rights. Accordingly, the kick-out rights held by limited partner F (37.5%) are excluded from the analysis. Therefore, when calculating whether a simple majority of the limited partners can remove the general partner, only the remaining 62.5% of kick-out rights held by the limited partners A through E are included. A simple majority of limited partners A through E cannot remove the general partner: Three of five limited partners would have only 37.5% (3 * 12.5%) of the kick-out rights, which is insufficient to remove the general partner.
- Step 2: Do limited partners with equity at risk hold substantive participating rights?
  - No. No limited partners hold substantive participating rights. Therefore, the limited partners with equity at risk collectively lack power.

3.3.3.2 Participating Rights When Evaluating a Limited Partnership

FASB REFERENCES

ASC 810-10-15-14(b)(1)(ii)(02), ASC 810-10-20: Ordinary Course of Business, Participating Rights (Voting Interest Entity Definition), and Protective Rights (Voting Interest Entity Definition), ASC 810-10-25-11 through 25-13, ASC 810-10-25-14C, and ASC 810-10-55-1

When the legal entity is a limited partnership, the evaluation of whether the limited partners with equity at risk collectively lack power focuses on whether the limited partners with equity at risk have substantive kick-out rights (see Section 3.3.3.1) or participating rights. The voting interest entity definition of participating rights is used to make this assessment for a limited partnership.

VOTING INTEREST ENTITY DEFINITION

Participating rights

Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

ASC 810-10-20 defines ordinary course of business as "*decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. The ordinary course of business does not include self-dealing transactions.*"

Participating rights must be substantive (see Section 3.3.4.2) to be considered when determining whether the limited partners with equity at risk collectively lack power.

Correctly discerning between participating and protective rights is important because protective rights do not affect whether the limited partners with equity at risk collectively lack power.

VOTING INTEREST ENTITY DEFINITION AND INTERPRETIVE GUIDANCE

Protective rights

Protective rights are rights that "*do not allow the limited partners… to participate in significant financial and operating decisions of the limited partnership… that are made in the ordinary course of business.*" Protective rights may apply only in exceptional circumstances and include rights to:

- Approve or veto fundamental changes in the activities of a legal entity, such as:
  - Amending the legal entity's governing documents
  - Selling substantially all the legal entity's assets
  - Undertaking activities that change the legal entity's credit risk
  - Removing the decision maker upon bankruptcy or breach of contract
  - Liquidating the legal entity or causing the legal entity to enter bankruptcy
- Approve or veto administrative decisions, such as:
  - Selecting the location of the legal entity's headquarters or the legal entity's name
  - Selecting the legal entity's auditor or accounting policies
  - Restricting specific activities of a franchisee to preserve the franchisor's brand
- Approve or veto self-dealing (related party) transactions, such as:
  - Pricing on transactions between the general partner and the legal entity
  - Entering contracts between the legal entity and the general partner's (or decision maker's) related parties

Such rights are designed to protect the holder's interests and do not affect whether the limited partners with equity at risk collectively lack power.

ASC 810 provides the following examples of substantive participating rights and states that these examples are illustrative, not exhaustive.

- Establishing operating and capital decisions, including budgets, in the ordinary course of business
- Selecting, terminating, and setting the compensation of management responsible for implementing the investee's policies and procedures

The rights above are participating rights because in the aggregate they allow the holders to participate in significant financial and operating decisions made in the ordinary course of the legal entity's business. Individual rights (for example, the right to veto management's termination) are evaluated based on the facts and circumstances to determine if they are participating rights.

The following list (which is not exhaustive) includes decisions that might be significant financial and operating decisions depending on whether such activities are expected in the legal entity's ordinary course of business.

- Financing activities, such as incurring indebtedness, issuing equity, and paying distributions and dividends
- Buying or selling significant assets; executing leases; managing credit risk; maintaining assets; and making capital expenditures
- R&D for new drug candidates, products, or technologies; buying or developing media content
- Extending loans or credit, writing insurance policies, and establishing credit or risk management policies
- Executing collective bargaining agreements with unions
- Establishing investment strategies and buying or selling investments or other financial assets
- Manufacturing, distributing, and selling products, including executing supplier contracts; pricing; and setting sales strategies
- Servicing and making decisions about delinquent or defaulted financial assets
- Executing provider and payor contracts, setting patient care policies, and providing patient care
- Initiating or resolving a lawsuit

When the general partner outsources significant financial and operating decisions, the limited partners' rights to participate in terminating that arrangement may be participating rights and require further evaluation. The ability to direct administrative functions, such as accounting or tax matters, are **not** significant financial and operating decisions of a limited partnership.

CONSIDER THE LEGAL ENTITY'S PURPOSE AND DESIGN WHEN EVALUATING BENEFITS

Determining whether a right is participating or protective requires understanding which decisions are expected to occur in the ordinary course of business.

For example, decisions about capital expenditures may be a significant financial and operating decision expected to occur in the ordinary course of business of a capital-intensive business (for example, a manufacturing business); if so, a right to approve or veto capital expenditures would be a participating right for that legal entity. In contrast, decisions about capital expenditures may not be a significant financial and operating decision expected to occur in the ordinary course of business of a service-based business (for example, asset management); such a right might be protective for that legal entity.

When a limited partner with equity at risk has the right to veto or block actions (for example, capital expenditures) above a threshold, the reporting entity must evaluate whether such action is expected to occur in the ordinary course of business (based on the legal entity's purpose and design) or only in exceptional circumstances. As discussed above, decisions made in the ordinary course of business involve matters normally expected to be addressed in directing the legal entity's current business activities regardless of whether the reporting entity expects the events or transactions that would necessitate such decisions to occur in the near term. However, it must be at least reasonably possible that those events or transactions will occur. Therefore, a veto right with a low threshold is more likely to be a participating right than a veto right with a high threshold. However, determining what constitutes a low or high threshold is a matter of judgment based on the legal entity's purpose and design.

If the limited partners with equity at risk lack substantive kick-out rights and participating rights, the legal entity is a VIE. Determining whether a right is participating or protective requires the application of professional judgment based on the facts and circumstances.

3.3.3.3 Examples of Evaluating the Power Characteristic for a Limited Partnership

FASB REFERENCES

ASC 810-10-55-205L through 55-205V

Examples 3-26 and 3-27 illustrate the evaluation of the power characteristic for a a limited partnership, including the evaluation of the limited partnerships' purpose and design and identification of the limited partnership's significant financial and operating decisions. The examples are not meant to be determinative.

EXAMPLE 3-26 (ADAPTED FROM ASC 810-10-55-205L THROUGH 55-205V): POWER ASSESSMENT FOR A LIMITED PARTNERSHIP — INVESTMENT FUND WITH NO PARTICIPATING RIGHTS

FACTS

- A fund manager (the general partner) formed an investment fund (a limited partnership) and sold partnership interests to investors (limited partners).
- The general partner marketed the partnership interests to the limited partners as an opportunity to earn returns by investing in a fund in which the general partner decides how to invest the fund's assets within the parameters and objectives in the limited partnership agreement.
- The general partner receives fees that are customary and commensurate and is not exposed to risk of loss. However, its equity ownership interest in the fund would absorb more than an insignificant amount of the fund's expected variability, which causes the fees to be variable interests (see Example 2-8).
- No limited partners are related parties of the general partner.
- The limited partners can redeem their interests within limits set forth by the fund, but such redemptions would not explicitly or implicitly cause the fund's dissolution or liquidation.
- The limited partners also do not have the ability to:
  - Remove the general partner or liquidate the fund without cause
  - Block or participate in the limited partnership's significant financial and operating decisions made in the ordinary course of business. For example, the limited partners do not have the right to participate in:
    - Approving budgets
    - Hiring, firing, and compensating management
    - Choosing and managing the investments in the fund

CONCLUSION

The limited partners with equity at risk collectively lack power. Therefore, the fund is a VIE. See Example 4-28 for the identification of its primary beneficiary.

ANALYSIS

- Step 1: Does a simple majority or lower percentage of the unrelated limited partners with equity at risk hold substantive kick-out rights?
  - No. The limited partners with equity at risk do not have the ability to remove the general partner or liquidate the fund without cause or to cause such liquidation through redemptions.
- Step 2: Do limited partners with equity at risk hold substantive participating rights?
  - No. The fund was designed to create and pass along equity price risk (earn a return) on the investments in the fund to its interest holders. The limited partners with equity at risk do not have the ability to block or participate in significant financial or operating decisions made in the ordinary course of business; that is, they do not have substantive participating rights. Therefore, they lack power.

EXAMPLE 3-27: POWER ASSESSMENT FOR A LIMITED PARTNERSHIP — INVESTMENT FUND WITH PARTICIPATING RIGHTS

FACTS

- Assume the same facts as in Example 3-26, except a simple majority of limited partners with equity at risk can veto the general partner's decisions to buy or sell investments, and this right is substantive (see Section 3.3.4.2).

CONCLUSION

The limited partners with equity at risk collectively have power. The reporting entity must determine whether the fund has any other VIE characteristics.

ANALYSIS

- Step 1: Does a simple majority or lower percentage of the unrelated limited partners with equity at risk hold substantive kick-out rights?
  - No. The limited partners with equity at risk do not have the ability to remove the general partner or liquidate the fund without cause or to cause such liquidation through redemptions.
- Step 2: Do limited partners with equity at risk hold substantive participating rights?
  - Yes. The fund was designed to create and pass along equity price risk (earn a return) on the investments in the fund to its interest holders. By simple majority vote, the limited partners with equity at risk have the ability to block or participate in decisions about buying and selling investments, which are significant financial or operating decisions made in the ordinary course of business. Therefore, they collectively have power.

3.3.4 Evaluating Whether Rights Are Substantive

FASB REFERENCES

ASC 810-10-15-13A through 15-13B

Only substantive terms and arrangements, whether contractual or noncontractual, are considered when evaluating whether kick-out and participating rights are substantive. Nonsubstantive rights are disregarded.

BDO INSIGHTS — DETERMINING WHETHER KICK-OUT RIGHTS OR PARTICIPATING RIGHTS ARE SUBSTANTIVE

When evaluating the substance of kick-out rights and participating rights, it is important to consider:

- The economic and business purpose and design of terms and arrangements (see Section 2.2.2.2)
- The ways in which terms and arrangements vary from what is typical in the industry or from other similar arrangements involving the reporting entity
- The parties' economic motivations and relationships with each other
- The legal enforceability of terms and provisions

Determining whether kick-out rights or participating rights are substantive requires the application of professional judgment based on the facts and circumstances.

3.3.4.1 Evaluating Whether Kick-out Rights Are Substantive

FASB REFERENCES

ASC 810-10-25-14A

The determination of whether kick-out rights are substantive is based on all facts and circumstances. To be substantive, the holders of kick-out rights must have the ability to exercise those rights if they choose to do so (there cannot be any significant barriers to exercising such rights). Examples of such barriers include:

Rights subject to conditions making it unlikely they will be exercisable; for example, conditions that severely limit or change the exercise period.
Financial penalties or operational barriers related to dissolving (liquidating) the legal entity or replacing the general partner, managing member, or decision maker, which would act as a significant disincentive for dissolution (liquidation) or removal.
The lack of an adequate number of qualified replacement general partners, managing members, or decision makers or of adequate compensation to attract a qualified replacement.
The absence of an explicit, reasonable mechanism in the governing documents or in the applicable laws or regulations by which the party can call for and conduct a vote to exercise those rights.
An inability to get the information necessary to exercise kick-out rights.

FACTORS TO CONSIDER WHEN ASSESING KICK-OUT RIGHTS

When evaluating whether a kick-out right is substantive, all facts and circumstances (such as those discussed in Section 3.3.4.2) are considered. The factors above are not a checklist. However, the likelihood that a kick-out right will be exercised is **not** considered when assessing whether it is substantive. Reaching a conclusion about whether a kick-out right is substantive requires the application of professional judgment based on the facts and circumstances.

Examples 3-28 and 3-29 illustrate the evaluation of whether kick-out rights are substantive.

EXAMPLE 3-28: EVALUATING SUBSTANCE OF KICK-OUT RIGHTS (FINANCIAL BARRIERS)

FACTS

- A general partner and two limited partners with equity at risk formed a limited partnership (the legal entity). The limited partners are not under common control with or acting on the general partner's behalf.
- The general partner has the right to make the limited partnership's significant financial and operating decisions.
- One limited partner has the unilateral right to replace the general partner without cause at any time, but if it does so, the general partner receives a significant termination payment. The limited partnership must also compensate the replacement general partner.

CONCLUSION

The kick-out right is not substantive because there is a significant barrier to exercise.

ANALYSIS

- While the right to remove the general partner is exercisable without cause, the termination payment (on top of paying the replacement general partner) is a significant barrier preventing exercise of this right. Therefore, the kick-out right is not substantive.

EXAMPLE 3-29: EVALUATING SUBSTANCE OF KICK-OUT RIGHTS (ABSENCE OF A QUALIFIED REPLACEMENT)

FACTS

- A general partner and limited partner with equity at risk formed a limited partnership (the legal entity) to research and develop and market several drug candidates. The limited partner is not under common control with or acting on the general partner's behalf.
- Through its equity at risk, the general partner has the right to the significant financial and operating decisions.
- The limited partner has the right to remove the general partner without cause; however, the general partner is the only party with the specialized knowledge regarding R&D for these drug candidates.

CONCLUSION

The kick-out right is not substantive because there is a significant barrier to exercise.

ANALYSIS

- While the right to remove the general partner is exercisable without cause, the absence of a qualified replacement for the general partner (because of its specialized knowledge regarding the R&D for these drug candidates) is a significant barrier preventing exercise of this right. Therefore, the kick-out right is not substantive.

3.3.4.2 Evaluating Whether Participating Rights Are Substantive

FASB REFERENCES

ASC 810-10-25-13 and ASC 810-10-55-1

The determination of whether participating rights are substantive is based on all facts and circumstances, including:

Disparity of rights	The significance of the investors' economic interests in the legal entity or the number of parties needed to exercise the participating rights may indicate the rights are nonsubstantive. ▶ The higher the disparity in ownership interests between the majority owner and the other shareholders or limited partners, the more likely the participating rights are nonsubstantive. Conversely, the lower that disparity, the more likely that the participating rights are nonsubstantive. ▶ The greater the number of parties that must agree to exercise the participating rights, the less likely the participating rights are substantive.
Decision-making and governance	The level at which decisions are made based on the governing documents (for example, by shareholders or limited partners versus by the board) may indicate whether the participating rights are nonsubstantive. ▶ For matters put to a vote of shareholders or limited partners, a reporting entity evaluates whether other investors, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on such matters.
Related parties and de facto agents	The relationships between the majority and other shareholders or limited partners may indicate the participating rights are nonsubstantive. ▶ The closer the relationship, the less likely it is that the participating rights are substantive. For example, if a member of the majority owner's immediate family holds the participating right, the right likely is nonsubstantive.
Buy-out and call provisions	The right of a majority owner to buyout or call the interests held by the party with the participating right for fair value (or less) may indicate the participating right is nonsubstantive. ▶ If such a buyout **is** prudent, feasible, and substantially within the majority owner's control, the participating right is nonsubstantive because it is negated by the buyout right. ▶ If such a buyout is **not** prudent, feasible, and substantially within the majority owner's control, the participating right may be substantive. A buyout is not prudent, feasible, and substantially within the majority owner's control if, for example, the party with the participating right either: • Controls technology critical to the legal entity • Is the principal source of funding for the legal entity

Consequences of exercising approval or veto rights	The lack of consequences resulting from exercising a participating right may indicate the right is nonsubstantive. ▶ If the exercise of a participating right does not affect a legal entity's significant financial and operating activities, the participating right might be nonsubstantive. For example: • If a shareholder or limited partner can block the approval of an operating budget for a legal entity that is a mature business for which year-to year operating budgets are not expected to vary significantly and if so, the business can simply revert to the prior year's budget adjusted for inflation, the right to block the operating budget's approval would likely be nonsubstantive. In contrast, the right to block the operating budget of an early-stage or growing business would likely be substantive. • If the legal entity can circumvent the participating right (for example, by buying instead of leasing an asset, and the holder has the right to block leasing but not buying assets) the participating right would likely be nonsubstantive. ▶ If one party has the right (after escalation or negotiation) to break a tie to resolve a matter (often referred to as a "deadlock provision"), the other party's right is nonsubstantive.
Exercise period	The conditions for exercise or the limits on the exercise period may indicate whether the participating right is nonsubstantive. ▶ If a participating right that was exercisable lapses, that participating right would become nonsubstantive. ▶ If the participating right is contingent on factors outside the holder's control, it would likely be nonsubstantive.

FACTORS TO CONSIDER WHEN ASSESSING PARTICIPATING RIGHTS

When evaluating whether a participating right is substantive, all facts and circumstances (such as those discussed in Section 3.3.4.1) are considered. The factors above are not a checklist. However, the likelihood that a participating right will be exercised is **not** considered when assessing whether it is substantive. Reaching a conclusion about whether a participating right is substantive requires the application of professional judgment based on the facts and circumstances.

3.4 THE OBLIGATION TO ABSORB EXPECTED LOSSES

FASB REFERENCES

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

Expected losses	A legal entity is a VIE if the holders of the equity at risk **collectively** lack the obligation to absorb the legal entity's expected losses.

The holders of the equity at risk (as a group) do not have the obligation to absorb the legal entity's losses if the legal entity or other parties involved with the legal entity directly or indirectly protect the holders of the equity at risk from the obligation to absorb expected losses or if the holders of the equity at risk are guaranteed a return. Therefore, if the holders of the equity at risk are not exposed to expected losses on a first-dollar basis, the legal entity is a VIE. The holders of the equity at risk must lose their entire investment (suffer a total loss) before other variable interests absorb expected losses; otherwise, the legal entity is a VIE.

Instruments or arrangements that may protect the holders of the equity at risk from collectively absorbing the legal entity's expected losses include:

- Equity that is not at risk (see Example 3-33)
- Arrangements that reimburse the legal entity or the holders of the equity at risk for losses
- Some guarantees, such as:
  - A guarantee of the legal entity's debt that does not require the equity holders to lose their entire investment before the lender can pursue the guarantor
  - A residual value guarantee by a lessee on an asset that comprises more than 50% of the fair value of the lessor legal entity's total assets
  - A guarantee or credit enhancement on assets owned by the legal entity that comprise more than 50% of the fair value of the legal entity's total assets
  - A guaranteed return
- Fixed-price put options on assets owned by the legal entity that comprise more than 50% of the fair value of the entity's total assets
- Total-return swaps
- Cost-plus arrangements to purchase a majority of the legal entity's goods and services
- Purchase agreements (for example, forward contracts) or options with nonrefundable deposits

FOCUS ON WHETHER THE EQUITY AT RISK IS PROTECTED, NOT ON THE PROTECTED PARTIES

Even if an instrument other than equity at risk that protects the holders of the equity at risk from collectively absorbing the legal entity's expected losses is held by a party with equity at risk, the legal entity is still a VIE. That is, the evaluation focuses on whether the equity at risk is protected from the risk of loss by other instruments, not on the identity of the protected (or protecting) party (see Example 3-33).

To determine whether an instrument or arrangement related to the legal entity's assets (for example, a residual value guarantee on one of the legal entity's assets) protects the holders of the equity at risk from absorbing the legal entity's expected losses, the reporting entity first determines whether the instrument or arrangement is an interest in specified assets of the legal entity or a variable interest in that entity as a whole (see Section 2.4).

If the instrument is a variable interest in the legal entity as a whole… →	Expected losses absorbed by the instrument **are** expected losses of the legal entity. →	The instrument protects the holders of the equity at risk from absorbing the legal entity's expected losses, so the legal entity is a VIE (see Example 3-31).
If the instrument is **not** a variable interest in the legal entity as a whole… →	Expected losses absorbed by the instrument are **not** expected losses of the legal entity. →	The instrument does **not** protect the holders of the equity at risk from absorbing the legal entity's expected losses (see Example 3-32).

Instruments or arrangements that generally do **not** protect the holders of the equity at risk from collectively absorbing the legal entity's expected losses include:

- Equity at risk that shares losses disproportionately (as long as collectively, the holders of the equity at risk incur losses on their investments first)
- Debt with recourse only to the legal entity's general credit risk (generally, such debt is exposed to losses only after the holders of the equity at risk suffer a total loss on their investments)
- Guarantees and other arrangements that protect lenders or other variable interest holders only after the holders of the equity at risk lose their entire investments
- Routine and customary arrangements (such as insurance, indemnities, and similar arrangements) that include only standard terms and conditions. However, if such arrangements have nonstandard terms that protect the holders of the equity at risk from absorbing the legal entity's expected losses (that is, the losses the legal entity was designed to create and pass along to its interest holders), the arrangement may cause the legal entity to be a VIE.

BDO INSIGHTS — EVALUATING ROUTINE AND CUSTOMARY ARRANGEMENTS

When evaluating whether an insurance contract or similar arrangement is not routine or customary (and therefore protects the holders of the equity at risk from collectively absorbing the legal entity's expected losses), a reporting entity considers all facts and circumstances. For example, the following would generally not be considered routine or customary:

- An arrangement that transfers all or substantially all the legal entity's expected variability to the counterparty (for example, a total return swap)
- An arrangement that conveys decision-making rights over an activity that most significantly impact the legal entity's economic performance

Other facts and circumstances that may indicate an arrangement is not routine and customary and was designed to protect the holders of the equity at risk from absorbing the legal entity's expected losses include:

- Circumstances in which the counterparty has other variable interests in the legal entity
- An arrangement that relates to a majority of the legal entity's assets

Reaching a conclusion requires evaluating all facts and circumstances in the context of the legal entity's purpose and design. Even when such an arrangement causes the legal entity to be a VIE because the holders of the equity at risk are protected from losses, the counterparty does not automatically control the legal entity. More analysis is needed to identify its primary beneficiary (see Chapter 4).

Examples 3-30 through 3-34 illustrate the evaluation of whether an instrument protects the holders of the equity at risk from collectively absorbing the legal entity's expected losses.

EXAMPLE 3-30: LOSSES ARE SHARED WITH EQUITY THAT IS NOT AT RISK

FACTS

- Investor A and Investor B formed a legal entity, and each contributed $50,000 in cash in exchange for 50% of the legal entity's equity. All returns are shared pro rata.
- In conjunction with the legal entity's formation, the legal entity paid an upfront fee of $50,000 in exchange for Investor A's promise to provide services in the future to the legal entity.

CONCLUSION

The holder of the equity risk (Investor B) lacks the obligation to absorb the legal entity's expected losses. Therefore, the legal entity is a VIE.

ANALYSIS

- Investor A's equity is not at risk because the upfront fee is a contemporaneous return of its initial investment (see Section 3.2.2.3).
- The legal entity's expected losses are shared between equity at risk (held by Investor B) and equity that is not at risk (held by Investor A). Therefore, Investor B's equity at risk is not subject to a total loss on the investment before Investor A (which holds a variable interest other than equity at risk) absorbs the legal entity's expected losses.

EXAMPLE 3-31: RESIDUAL VALUE GUARANTEE THAT IS A VARIABLE INTEREST IN THE LEGAL ENTITY AS A WHOLE

FACTS

- Investor A formed a legal entity and contributed a warehouse with a fair value of $10 million in exchange for equity, which is at risk. The legal entity does not have other assets.
- The legal entity leased the warehouse to a third party, which guaranteed that the warehouse's residual value will be at least $7 million at the end of the lease term.

CONCLUSION

The holder of the equity at risk (Investor A) lacks the obligation to absorb the legal entity's expected losses. Therefore, the legal entity is a VIE.

ANALYSIS

- The warehouse is the legal entity's only asset, so its fair value is more than 50% of the fair value of the legal entity's assets. Therefore, the residual value guarantee on the warehouse is a variable interest in the legal entity as a whole (see Section 2.4). Accordingly, the expected losses related to the warehouse are **included** when evaluating whether the holders of the equity at risk collectively have the obligation to absorb the legal entity's expected losses (see Section 2.4.2.2).
- The residual value guarantee protects the holder of the equity at risk (Investor A) from a first-dollar loss on its investment. Therefore, the holder of the equity at risk lacks the obligation to absorb the legal entity's expected losses.

EXAMPLE 3-32: RESIDUAL VALUE GUARANTEE IS NOT A VARIABLE INTEREST IN THE LEGAL ENTITY AS A WHOLE

FACTS

- Investor A and Investor B formed a legal entity and contributed a manufacturing plant and a warehouse, respectively, to the legal entity in exchange for equity, which is at risk.
- The manufacturing plant and warehouse have a fair value of $12 million and $8 million, respectively. The legal entity does not have other significant assets.
- The legal entity's purpose and design is to sell goods manufactured at the plant and to lease the warehouse to a third party to provide a stable stream of cash flows, thereby reducing the overall risks to the investors.
- The lessee guaranteed that the warehouse's residual value will be at least $6 million at the end of the lease term. The lessee does not hold equity in the legal entity.

CONCLUSION

The holders of the equity at risk have the obligation to absorb the legal entity's expected losses. The reporting entity must evaluate whether the legal entity has any other VIE characteristics.

ANALYSIS

- The warehouse's fair value is 40% of the fair value of the legal entity's total assets and therefore less than 50% of the fair value of total assets. The lessee also does not hold equity in the legal entity. Therefore, the residual value guarantee on the warehouse is an interest in specified assets of the legal entity and not a variable interest in that entity as a whole. Accordingly, the expected losses related to the warehouse are **excluded** when evaluating whether the holders of the equity at risk collectively lack the obligation to absorb the legal entity's expected losses (see Section 2.4).
- Therefore, the residual value guarantee does not protect the holders of the equity at risk from having the obligation to absorb the legal entity's expected losses.

EXAMPLE 3-33: VARIABLE INTEREST IN THE LEGAL ENTITY AS A WHOLE IS HELD BY AN EQUITY HOLDER

FACTS

- Investor A and Investor B formed a legal entity, and each contributed cash to the legal entity in exchange for equity, which is at risk.
- The legal entity used the proceeds to buy a warehouse, which has a fair value of $8 million. The legal entity does not have other assets.
- The legal entity leased the warehouse to Investor B, which that the warehouse's residual value will be at least $6 million at the end of the lease term.

CONCLUSION

The holders of the equity at risk lack the obligation to absorb the legal entity's expected losses, so it is a VIE.

ANALYSIS

- The warehouse's fair value is more than 50% of the fair value of the legal entity's assets. Therefore, the residual value guarantee on the warehouse is a variable interest in the legal entity as a whole. Accordingly, the expected losses related to the warehouse are **included** when evaluating whether the holders of the equity at risk collectively have the obligation to absorb the legal entity's expected losses (see Section 2.4).
- The residual value guarantee protects the holders of the equity at risk, so they collectively lack the obligation to absorb the legal entity's expected losses. When evaluating whether the legal entity has this characteristic of a VIE, it is irrelevant that Investor B (the lessee that guaranteed the residual value) also has equity at risk.

3.5 THE RIGHT TO RECEIVE EXPECTED RESIDUAL RETURNS

FASB REFERENCES

ASC 810-10-15-14(b)(3)

Expected residual returns	A legal entity is a VIE if the holders of the equity at risk **collectively** lack the right to receive the legal entity's expected residual returns.

The holders of the equity at risk collectively lack the right to receive the legal entity's expected residual returns if their return is capped by the legal entity's governing documents or arrangements with other variable interest holders or the legal entity. "Capped" means the holders of the equity at risk do not have the right to receive or participate in the legal entity's expected residual returns above a threshold.

The return to the holders of the equity at risk is **not** capped by stock options, convertible debt, or similar interests because if those instruments are exercised or converted, the holders become equity investors. If interests other than the equity at risk prevent the holders of the equity at risk from having the right to receive the legal entity's expected residual returns, the legal entity is a VIE. For example, a fixed-price call option to acquire substantially all the legal entity's assets, or decision-maker fees that receive all the legal entity's expected residual returns above a fixed percentage, would cap the returns to holders of equity at risk and would cause the legal entity to be a VIE.

Because a reporting entity evaluates this characteristic of a VIE for the holders of the equity at risk **collectively**, disproportionately sharing expected residual returns among the holders of the equity at risk does not cause the legal entity to be a VIE. The holders of the equity at risk can also **share** expected residual returns with other parties that do not hold equity at risk, as long as the returns the holders of the equity at risk are entitled to receive are not capped (see Example 3-34 and Example 3-35). Therefore, this evaluation differs from the determination of whether the holders of the equity at risk lack the obligation to absorb the legal entity's expected losses (see Section 3.4).

Reaching a conclusion about whether the holders of the equity at risk collectively lack the right to receive the legal entity's expected residual returns requires the application of professional judgment based on the facts and circumstances and understanding the risks the legal entity was designed to create and pass along to its interest holders.

FOCUS ON WHETHER THE RETURNS TO THE HOLDERS OF THE EQUITY AT RISK ARE CAPPED

If an instrument other than equity at risk prevents the holders of the equity at risk from collectively having the right to receive the legal entity's expected residual returns, and that instrument is held by a party with equity at risk, the legal entity is still a VIE. The evaluation focuses on whether the returns to the holders of the equity at risk are capped by instruments other than equity at risk, not on the identity of the party whose returns are capped (see Example 3-35).

Examples 3-34 through 3-36 illustrate the evaluation of whether an instrument prevents the holders of the equity at risk from collectively having the right to receive the legal entity's expected residual returns.

EXAMPLE 3-34: EXPECTED RESIDUAL RETURNS SHARED WITH EQUITY THAT IS NOT AT RISK — NOT CAPPED

FACTS

- Investor A and Investor B formed a legal entity, and each contributed cash to the legal entity in exchange for equity, which is at risk.
- Because neither Investor A nor Investor B has the required level of expertise to run the legal entity's business, they enter a management agreement with a third party to run the business in exchange for receiving 20% of its equity. The equity is nonforfeitable and is the only compensation for services rendered by the third party, so it is not at risk (see Section 3.2.2.3).
- Investor A and Investor B share the remaining 80% of returns.

CONCLUSION

The holders of the equity at risk collectively have the right to receive the legal entity's expected residual returns. The reporting entity must evaluate whether legal entity has any other VIE characteristics.

ANALYSIS

- The legal entity's expected residual returns are shared by the holders of the equity at risk (Investor A and Investor B, which collectively receive 80% of the returns) and the third party (which receives 20% of the returns).
- However, the returns to the holders of the equity at risk are not capped. Therefore, the fact that the third party (which does not have equity at risk) receives 20% of the returns does **not** prevent the holders of the equity at risk from collectively having the right to receive the legal entity's expected residual returns.

EXAMPLE 3-35: EXPECTED RESIDUAL RETURNS SHARED WITH EQUITY THAT IS NOT AT RISK — CAPPED

FACTS

- Assume the same facts as in Example 3-34, except the third party receives **all** returns of the legal entity once Investor A and Investor B receive a cumulative return of 10% on their investment.

CONCLUSION

The holders of the equity at risk collectively lack the right to receive the legal entity's expected residual returns. Therefore, the legal entity is a VIE.

ANALYSIS

- The expected residual returns to the holders of the equity at risk are capped at a 10% cumulative return on their investment, and the third party receives all returns above that threshold. Therefore, this arrangement prevents the holders of the equity at risk (Investor A and Investor B) from collectively having the right to receive the legal entity's expected residual returns.

EXAMPLE 3-36: FIXED-PRICE CALL OPTION IS A VARIABLE INTEREST IN THE LEGAL ENTITY AS A WHOLE

FACTS

- Investor A formed a legal entity and contributed an intangible asset with a fair value of $1 million in exchange for equity, which is at risk. The legal entity does not have other assets.
- The legal entity licensed the intellectual property to a third party, which has the right to purchase the intellectual property for $1.1 million at the end of the license period.

CONCLUSION

The holder of the equity at risk (Investor A) lacks the rights to receive the legal entity's expected residual returns. Therefore, the legal entity is a VIE.

ANALYSIS

- The intellectual property is the only asset the legal entity owns, so its fair value is more than 50% of the legal entity's total assets, and the fixed-price purchase option is a variable interest in that entity as a whole (see Section 2.4). Accordingly, the expected residual returns related to the intellectual property are **included** when evaluating whether the holders of the equity at risk collectively have the right to receive the legal entity's expected residual returns.
- The expected residual returns to the holder of the equity at risk (Investor A) are capped by the fixed-price purchase option. Therefore, the holder of the equity at risk lacks the right to receive the legal entity's expected residual returns.

3.6 EQUITY HOLDERS HAVE NONSUBSTANTIVE VOTING RIGHTS (ANTIABUSE TEST)

FASB REFERENCES

ASC 810-10-15-14(c)

Voting rights are nonsubstantive

A legal entity is a VIE if the voting rights are nonsubstantive, because **both** criteria are met:

- The voting rights of some investors are not proportional to their economic exposure to the legal entity (see Section 3.6.1).
- Substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights, including that investor's related parties and specific de facto agents (see Section 3.6.2).

This characteristic of a VIE is often referred to as the "antiabuse test."

To determine whether a legal entity is a VIE under the antiabuse test, a reporting entity follows two steps.

STEP 1

Identify disproportionality between the voting rights and economics of any investor (without including related parties and de facto agents) (see Section 3.6.1).

STEP 2

Assess whether substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights (including its related parties and specific de facto agents) (see Section 3.6.2).

The antiabuse test is meant to identify situations in which a reporting entity may have attempted to structure a legal entity with nonsubstantive voting rights to avoid consolidation while retaining substantially all the benefits from the legal entity. Although the test is designed to prevent abuses of the consolidation model, any legal entity that fails is a VIE (even if there is a valid business reason for its structure); the reporting entity must identify the legal entity's primary beneficiary. The SEC staff discussed the intent and application of the antiabuse test.

SEC STAFF GUIDANCE

Remarks before the 2003 AICPA Conference on Current SEC Developments

Eric Schuppenhauer, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *The staff has received a number of inquiries on how to apply the guidance contained in [ASC 810-10-15-14(c)]. That sentence states, in part: "[t]he equity investors as a group also are considered to lack characteristic (b)(1) if (i) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both and (ii) substantially all of the 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.*
>
> *The intent of this provision is to move the consolidation analysis from the voting interests model to the variable interests model in those instances where it is clear that the voting arrangements have been skewed such 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 other words, it is an abuse-prevention mechanism intended to identify instances where there is something occurring in the relationship that indicates the voting arrangements are not useful in identifying who truly controls the entity.*
>
> *The first part of the provision is an assessment of whether the votes are consistent with the economics. It's pretty straight-forward.*
>
> *The second part of this provision is where more judgment is involved. In the event that a registrant concludes that it has disproportionately few voting rights compared to its economics, there must be an assessment of whether substantially all of the activities of the entity either involve or are conducted on behalf of the registrant. There is no "bright-line" set of criteria for making this assessment. All facts and circumstances, qualitative and quantitative, should be considered in performing the assessment.* [Footnotes omitted.]

3.6.1 Identify Disproportionality Between Voting Rights and Economics

FASB REFERENCES

ASC 810-10-15-14(c)(1)

STEP 1

Identify disproportionality between the voting rights and economics of any investor (without including related parties and de facto agents)

The first criterion in the antiabuse test evaluates whether the voting rights of some investors are not proportional to their obligations to absorb the legal entity's expected losses, their rights to receive the legal entity's expected residual returns, or both (collectively referred to as "economics"). To assess this criterion, a reporting entity must determine whether disproportionality exists for **any** investor, rather than solely for the reporting entity.

Disproportionality between voting rights and economics is common and does not arise solely because of attempts to circumvent consolidation. In many cases, disproportionality results from legitimate business reasons. For example, other investors have disproportionately fewer (or disproportionately more) voting rights when an equity investor:

- Receives preferential profit allocations or distributions over other equity investors, while voting rights are pro rata
- Holds debt or provides a guarantee that absorbs some of the legal entity's expected losses (see Example 3-38)

Rights held by an investor's related parties and de facto agents are **not** ascribed to the investor when determining if the voting rights and economics are disproportional. However, an investor must determine whether substantially all the legal entity's activities involve or are conducted on behalf of the investor with disproportionately fewer voting rights (collectively including its related parties and specific de facto agents) when applying Step 2 of the antiabuse test (see Section 3.6.2).

BDO INSIGHTS — IDENTIFYING DISPROPORTIONALITY

Generally, we believe the first criterion of the antiabuse test is met if any disproportionality exists between an investor's voting rights and economics (for example, 45% voting rights and 46% economics). Even small differences can lead to the conclusion that an investor's voting rights are not proportional to its economics. However, for a legal entity to be a VIE under the antiabuse test, it also must meet the second criterion discussed in Section 3.6.2. Therefore, failing the first criterion does not automatically cause the legal entity to be a VIE.

CONSIDER ALL VARIABLE INTERESTS

When evaluating whether an investor's voting rights are proportional to its economics from the legal entity, a reporting entity considers the economics from each party's variable interests, not only that party's equity at risk.

BDO INSIGHTS — DETERMINING THE VOTING RIGHTS HELD BY LIMITED PARTNERS

Limited partners often have disproportional voting rights and economics because the general partner often directs the activities that most significantly impact the limited partnership's economic performance regardless of the general partner's economic interest. If the limited partners with equity at risk collectively do not have substantive kick-out rights or participating rights, the limited partnership is a VIE (see Section 3.3.3), and the antiabuse test is irrelevant. However, when the limited partners with equity at risk collectively have substantive kick-out rights or participating rights, the reporting entity must determine whether the legal entity is a VIE under the antiabuse test, (unless the legal entity has other VIE characteristics).

Because ASC 810 does not describe how to determine the proportion of voting rights held by limited partners that hold substantive kick-out rights or participating rights, making such a determination requires the application of professional judgment based on the facts and circumstances. For example, if one limited partner with equity at risk has a veto right that is a substantive participating right, we believe the general partner and limited partner are considered to each have 50% of the voting rights for the disproportionality assessment.

Examples 3-37 and 3-38 illustrate how to evaluate whether any investor has disproportionately fewer voting rights.

EXAMPLE 3-37: DISPROPORTIONALITY ARISING FROM THE GOVERNING DOCUMENTS

FACTS

- Investor A and Investor B formed a legal entity and contributed cash for 60% and 40%, respectively, of its equity, which is at risk. All returns are shared pro rata.
- The legal entity has no other variable interests other than equity.
- The legal entity's governing documents require the unanimous consent of all equity holders to make decisions about the activities that most significantly impact the legal entity's economic performance.

CONCLUSION

Investor A has disproportionately fewer voting rights compared to its economics. Therefore, Step 1 of the antiabuse test is met; the reporting entity performs Step 2 to determine whether the legal entity is a VIE.

ANALYSIS

- Step 1: Identify disproportionality between the voting rights and economics of any investor (without including related parties and de facto agents).
  - Investor A is entitled to 60% of the legal entity's economics but effectively holds only 50% of the voting rights because the governing documents require the equity holders' unanimous consent to make decisions about the activities that most significantly impact the legal entity's economic performance. Accordingly, Investor A has disproportionately fewer voting rights compared to its economics, so Step 1 of the antiabuse test is met.

EXAMPLE 3-38: DISPROPORTIONALITY ARISING FROM OTHER VARIABLE INTERESTS

FACTS

- Investor A and Investor B formed a legal entity, and each contributed $10 million in exchange for 50% of the legal entity's equity. All returns are shared pro rata.
- The legal entity's governing documents require all decisions about the activities that most significantly impact the legal entity's economic performance to be made by a majority vote of the board, which consists of two directors appointed by Investor A and two directors appointed by Investor B. Neither party has a tie-breaking vote.
- Investor A also loaned $2 million to the legal entity.

CONCLUSION

Investor A has disproportionately fewer voting rights compared to its economics. Therefore, Step 1 of the antiabuse test is met; the reporting entity performs Step 2 to determine whether the legal entity is a VIE.

ANALYSIS

- Step 1: Identify disproportionality between the voting rights and economics of any investor (without including related parties and de facto agents).
  - Each investor has proportional equity, voting rights, and board representation (for example, Investor A effectively holds 50% of the voting rights and 50% of the equity). However, Investor A absorbs the majority of economics because of its loan to the legal entity. Accordingly, Investor A has disproportionately fewer voting rights compared to its economics, so Step 1 of the antiabuse test is met.

3.6.2 Assess Whether Substantially All the Legal Entity's Activities Involve or Are Conducted on Behalf of an Investor With Disproportionately Fewer Voting Rights

FASB REFERENCES

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

STEP 2

Assess whether substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights (including its related parties and specific de facto agents)

Disproportionality between voting rights and economics (see Section 3.6.1) is not the only criterion for a legal entity to be a VIE under the antiabuse test. Substantially all the legal entity's activities must also involve or be conducted on behalf of the investor with disproportionately fewer voting rights for the legal entity to be a VIE.

Unlike in Step 1, which evaluates the voting and economic rights held by each investor without including the investor's related parties and de facto agents, Step 2 assesses whether the activities involve or are conducted on behalf of the investor with disproportionately fewer voting rights, **including** its related parties and specific de facto agents (see Chapter 5). Therefore, if all parties with variable interests in a legal entity are related parties or (specific) de facto agents of the investor with disproportionately fewer voting rights, the legal entity automatically meets the criterion in Step 2. However, for this evaluation, the reference to de facto agents **excludes** a party that is a de facto agent solely because of an agreement that restricts it from transferring its interests in the legal entity without prior approval of the investor with disproportionately fewer voting rights (see Section 5.3.4).

There is no quantitative threshold used to evaluate whether the substantially all criterion is met. Although economics are one factor to consider, the determination is primarily qualitative. Reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

In practice, a reporting entity might consider the list of factors below (which is neither a checklist nor exhaustive) in determining whether substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights. The importance of these factors varies depending on the legal entity's purpose and design. No factor is determinative and not all factors must be present to conclude that substantially all the legal entity's activities involve or are conducted on behalf of the investor with disproportionately fewer voting rights (including its related parties and specific de facto agents).

The legal entity buys or sells most of its products or services from or to the equity investor with disproportionately fewer voting rights (the greater the proportion, the stronger the indicator).
The investor with disproportionately fewer voting rights has a call option to buy other variable interests in the legal entity (a fixed-price, in-the-money, noncontingent option is a stronger indicator than a fair value, contingently exercisable option).
Other investors have put options to sell some or all of their variable interests to the equity investor with disproportionately fewer voting rights.
Most of the legal entity's assets were acquired from the investor with disproportionately fewer voting rights (the greater the proportion, the stronger the indicator).
Most of the legal entity's assets are leased to or from the investor with disproportionately fewer voting rights (the greater the proportion, the stronger the indicator).
Employees of the equity investor with disproportionately fewer voting rights manage the legal entity's operations (for example, as board members, advisors, or like employees through loan-staffing or outsourcing).
The legal entity's employees receive compensation tied to the stock price or operating results of the equity investor with disproportionately fewer voting rights.
The legal entity's operations are substantially similar in nature, complementary to, or an extension of the activities of the equity investor with disproportionately fewer voting rights.
The legal entity's operations are more important to the equity investor with disproportionately fewer voting rights than to other variable interest holders.
The equity investor with disproportionately fewer voting rights participates in making decisions about the activities that most significantly impact the legal entity's economic performance.
The equity investor with disproportionately fewer voting rights is obligated to fund the legal entity's operating losses, or the legal entity is financially dependent on that equity investor.
The equity investor with disproportionately fewer voting rights is explicitly or implicitly obligated to fund most of the capital of the legal entity (the greater the obligation, the stronger the indicator). (See Section 2.6 on identifying implicit variable interests).
The legal entity outsources the activities that most significantly impact its economic performance to the equity investor with disproportionately fewer voting rights or vice versa.
The legal entity performs R&D activities critical to the economic performance of the equity investor with disproportionately fewer voting rights or vice versa.
The economics are heavily skewed toward the equity investor with disproportionately fewer voting rights.

EXAMPLE 3-39: THE SUBSTANTIALLY ALL TEST IS NOT MET

FACTS

- Investor A and Investor B (which are not related parties or de facto agents) formed a legal entity to manufacture and sell magnetic resonance imaging (MRI) scanners to hospitals and other medical facilities.
- Investor A is a hospital that holds 60% of the legal entity's equity, which is at risk.
- Investor B is a medical facility that provides various medical services, including imaging services, and holds 40% of the legal entity's equity, which also is at risk.
- The legal entity's governing documents require all equity holders (Investor A and Investor B) to unanimously agree on all decisions about the activities that most significantly impact the legal entity's economic performance.
- Investor A and Investor B's equity participates in the legal entity's profits and losses pro rata.
- The legal entity sells 60%, 30%, and 10% of the MRI scanners to Investor A, Investor B, and third-party customers, respectively.
- Investor B's CEO advises the legal entity's management on technological updates.
- The legal entity has no other variable interest holders.

CONCLUSION

The substantially all test is not met, so the legal entity is not a VIE under the antiabuse test. The reporting entity must determine whether the legal entity has any other VIE characteristics.

ANALYSIS

- Step 1: Identify disproportionality between the voting rights and economics of any investor (without including related parties and de facto agents).
  - Investor A holds 60% of the legal entity's equity but effectively holds only 50% of the voting rights because the equity holders must unanimously agree to make decisions about the activities that most significantly impact the legal entity's economic performance. Accordingly, Investor A has disproportionately fewer voting rights compared to its economics, so Step 1 of the anti-abuse test is met.
- Step 2: Assess whether substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights (including its related parties and specific de facto agents).
  - The reporting entity considered the following factors:
    - Investor A and Investor B are not related parties or de facto agents.
    - The legal entity's operations are not substantially similar in nature to Investor A's operations because a hospital has many activities unrelated to imaging services. Likewise, Investor B provides many medical services aside from imaging services.
    - Both Investor A and Investor B participate in making decisions about the activities that most significantly impact the legal entity's economic performance.
    - Investor A buys 60% of the legal entity's MRI scanners, which is not substantially all the legal entity's sales.
    - Investor B buys a significant portion of the legal entity's MRI scanners, and its CEO advises the legal entity's management, which indicates substantive involvement by Investor B.
- Based on that assessment, substantially all the legal entity's activities do not involve and are not conducted on behalf of Investor A (the investor with the disproportionately fewer voting rights), so Step 2 of the antiabuse test is not met. Therefore, the legal entity is not a VIE under the antiabuse test.

EXAMPLE 3-40: THE SUBSTANTIALLY ALL TEST IS MET

FACTS

- Assume the same facts as in Example 3-39, except Investor A and Investor B are related parties.

CONCLUSION

The legal entity is a VIE under the antiabuse test.

ANALYSIS

- Step 1: Identify disproportionality between the voting rights and economics of any investor (without including related parties and de facto agents).
  - Consistent with the analysis in Example 3-39, Investor A holds 60% of the legal entity's shares but effectively holds only 50% of the voting rights because the equity holders' must unanimously agree to make decisions about the activities that most significantly impact the legal entity's economic performance. The fact that Investor A and Investor B are related parties is irrelevant when performing Step 1. Accordingly, Investor A has disproportionately fewer voting rights compared to its economics, so Step 1 of the antiabuse test is met.
- Step 2: Assess whether substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights (including its related parties and specific de facto agents).
  - Because Investor A and Investor B are related parties, the reporting entity considered the following factors:
    - Only 10% of the legal entity's products are sold to third parties.
    - Collectively, Investor A and Investor B make all decisions that significantly impact legal entity's economic performance.
    - Collectively, Investor A and Investor B hold 100% of legal entity's variable interests.
- Based on that assessment, and because Investor A and Investor B are related parties, substantially all the legal entity's activities involve or are conducted on behalf of Investor A (the investor with disproportionately fewer voting rights, including its related party, Investor B), so Step 2 of the antiabuse test is met. Therefore, the legal entity is a VIE.

3.7 RECONSIDERATION OF VIE STATUS

FASB REFERENCES

ASC 810-10-35-4

The initial determination of whether a legal entity is a VIE is reconsidered if **any** of the following occur:

- The legal entity's governing documents or contractual arrangements change in a manner that affects the characteristics or adequacy of the equity at risk.
- The equity at risk or some part thereof is returned to equity investors and other interests become exposed to the legal entity's expected losses.
- The legal entity begins new activities or obtains more assets beyond those anticipated at the later of its inception or the latest reconsideration event, which increase its expected losses.
- The legal entity receives more equity at risk or changes its activities in a way that decrease its expected losses.
- Facts and circumstances change, causing the holders of the equity at risk collectively lose the power through voting rights or similar rights to direct the activities that most significantly impact the legal entity's economic performance.

The table shows common reconsideration events but is not an exhaustive list. A reporting entity should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances that could affect its analysis.

Activities of the entity	▶ Buying or developing new businesses or assets or changing the legal entity's business model in a way that increases expected losses (and was not expected as part of the legal entity's purpose and design at the most recent evaluation date). ▶ Selling businesses or assets, which decreases expected losses (and was not expected as part of the legal entity's purpose and design at the most recent evaluation date).
Terms of contracts	▶ Amending governing documents (for example, articles of incorporation, bylaws, partnership agreements, membership agreements, operating agreements, or voting agreements) in a manner that affects the characteristics or adequacy of the equity at risk; for example, changing the board's size or composition. ▶ Changing decision-making rights for service providers (for activities that most significantly impact the legal entity's economic performance). ▶ Restructuring, refinancing, or modifying debt. ▶ Filing for or emerging from bankruptcy (see Section 6.5.2). ▶ Defaulting on loan covenants the legal entity cannot cure and for which there are no significant barriers preventing the lender from foreclosing. ▶ Lapsing or expiring substantive kick-out rights or participating rights.
Nature of interests	▶ Issuing more equity for cash (or other assets) or receiving such consideration in response to a capital call on existing equity. ▶ Redeeming or repurchasing equity. ▶ Modifying the terms of equity instruments in a manner that changes the characteristics or adequacy of the equity at risk. ▶ Issuing guarantees, puts, or call options.

A legal entity that was not previously a VIE does not become a VIE simply because it incurs operating losses that reduce its equity at risk. That said, losses that reduce the equity at risk may increase the likelihood of a reconsideration event (for example, restructuring debt). If a reconsideration event occurs, losses are considered in the context of the legal entity's purpose and design when evaluating whether the legal entity is a VIE.

Upon a reconsideration event, the reporting entity also evaluates the sufficiency of equity at risk based on the fair value of the equity at risk at that date (see Section 3.2).

BDO INSIGHTS — ONLY A SUBSTANTIVE CHANGE CAN CAUSE A RECONSIDERATION EVENT

Only a substantive transaction, change to an arrangement, or change in facts and circumstances can cause a reconsideration event. Nonsubstantive changes, such as changing a legal entity's fiscal year end or tax representative, do not cause a reconsideration event. Reaching a conclusion about whether a reconsideration event has occurred requires the application of professional judgment based on the facts and circumstances.

3.7.1 Modifications Because of Reference Rate Reform

FASB REFERENCES

ASC 848-10-15-3, ASC 848-20-15-2 through 15-3, and ASC 848-20-55-2

ASC 848, *Reference Rate Reform*, gives optional relief for contract modifications while a reporting entity transitions from London interbank offered rate (LIBOR) or from another reference rate expected to be discontinued because of reference rate reform to another interest rate. The relief is available only if specified criteria are met, and it expires December 31, 2024. Thereafter, a reporting entity evaluates whether a change in a term or arrangement is a reconsideration event as discussed in Section 3.7.

The modification meets the criteria in ASC 848.	**Example:** The modification only replaces a reference rate in the scope of ASC 848 (for example, LIBOR) with another interest rate index.	The reporting entity does not need to reconsider whether the legal entity is a VIE.
The modification does not meet the criteria in ASC 848 or is effective after the relief's expiration.	**Example:** The modification changes the amount or timing of contractual cash flows and is not solely related to replacing the reference rate.	The reporting entity evaluates whether a reconsideration event has occurred.

See ASC 848 for more details on applying this guidance.

Chapter 4 — Identifying the Primary Beneficiary

4.1 OVERVIEW

If a legal entity is a VIE, the next step is to determine whether the reporting entity controls and consolidates the VIE — that is, to identify the VIE's primary beneficiary. A reporting entity is the primary beneficiary and consolidates a VIE when it has a controlling financial interest in the VIE. A reporting entity is the primary beneficiary of a VIE if it has power and economics.

Power	Power is the ability to direct the activities that most significantly impact the VIE's economic performance (see Section 4.2).
Economics	Economics is the obligation to absorb the VIE's losses or the right to receive benefits from the VIE that **could** potentially be significant to the VIE (see Section 4.3).

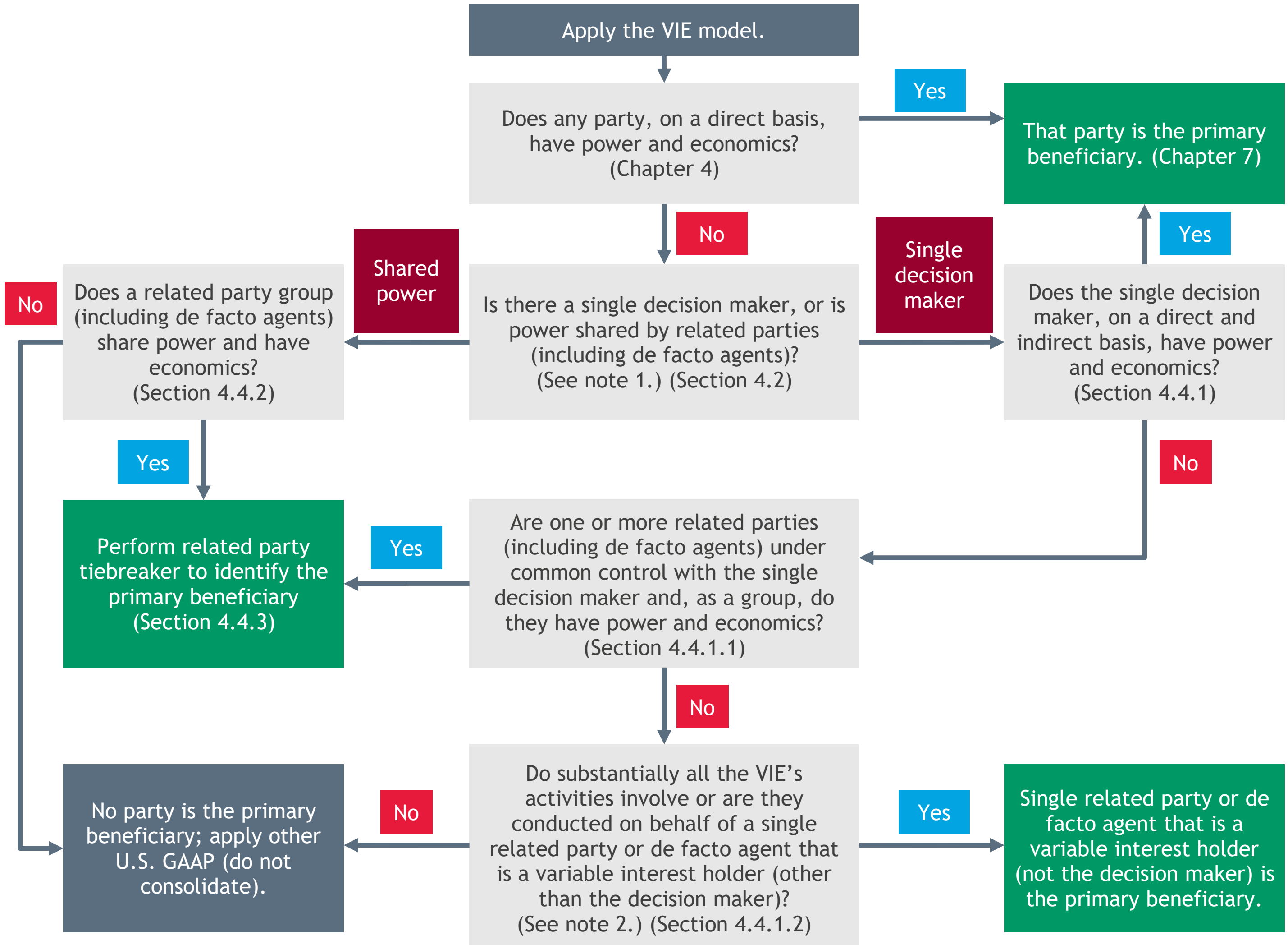
Identifying the primary beneficiary is mostly a qualitative assessment. Often, more than one party has economics, but only one party, if any, has power.

If no party individually is the primary beneficiary (no party individually has power and economics), the reporting entity must determine whether a related party group (including de facto agents) collectively has the characteristics of a primary beneficiary (that is, power and economics). That may require one party in the group to be identified as the primary beneficiary and consolidate the VIE (see Section 4.4).

The identification of the primary beneficiary is an ongoing assessment (see Section 4.5). Therefore, a reporting entity should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances that could affect its analysis.

See Section 4.6 for examples illustrating the identification of the primary beneficiary.

The following flowchart, adapted from ASC 810-10-05-6, illustrates how to identify the primary beneficiary.



- **Note 1:** See Section 4.2.3 for guidance when there appear to be multiple decision makers. One of these parties generally is identified as the single decision maker. See Section 4.2.4 for guidance when parties that are not related parties or de facto agents share power.
- **Note 2:** This step applies only if the reporting entity and its related party group (including de facto agents) have power and economics (but no party individually has power and economics) and are not under common control.

4.2 POWER

FASB REFERENCES

ASC 810-10-25-38 through 25-38B

To be the primary beneficiary, the reporting entity must have power over the VIE.

Power

Power is the ability to direct the activities that most significantly impact the VIE's economic performance.

To identify the party with power, the reporting entity must analyze the nature of the risks in the VIE (see Section 2.2.1) and determine the VIE's purpose and the variability it is designed to create and pass along to its interest holders (see Section 2.2.2). The reporting entity must then identify the activities that most significantly impact the VIE's economic performance (see Section 3.3.2.1) and determine how those activities are directed. The graphic illustrates these steps.

Analyze nature of risks → Determine entity's purpose → Identify significant activities → Determine how decisions are made

Once the reporting entity determines how decisions are made, it identifies the parties making those decisions. A party with the right to make the decisions about the activities that most significantly impact the VIE's economic performance is considered a decision maker. A reporting entity has power if it has the right to direct the activities that most significantly impact the VIE's economic performance, even if that right is triggered only if specific circumstances arise or specific events happen. A reporting entity does not have to exercise its rights to have power over a VIE.

DECISION MAKERS	DESCRIPTION
Single decision maker	A single decision maker that exercises its decision-making rights through a variable interest (for example, through a contract that is a variable interest or holding a majority of voting rights through equity) has power unless a single party holds substantive kick-out rights or participating rights (see Section 4.2.2).
Multiple decision makers	When there are multiple decision makers, identifying the party with power depends on whether the parties direct the same activities (see Section 4.2.3.1) or different activities (see Section 4.2.3.2).
Shared power	Two or more parties share power when the parties must unanimously consent or agree to make decisions about **all** activities that most significantly impact the VIE's economic performance. ▶ When parties that are not related parties or de facto agents share power, no party is the primary beneficiary (see Section 4.2.4). ▶ When related parties or de facto agents share power, the reporting entity performs the related party tiebreaker to identify the primary beneficiary (see Section 4.4.2).

See Section 4.6 for examples in several industries illustrating the identification of the activities that most significantly impact the VIE's economic performance and the party with power.

Sometimes, it is challenging to identify the party with power; for example, when:

- The VIE has limited ongoing decision-making and appears to be running on autopilot (see Section 3.3.2.1.1)
- The economics are disproportionate to decision-making (see Section 4.2.1)
- One party holds potential voting rights; for example, options (see Section 4.2.5)

In such situations, identifying the party or parties with power requires the application of professional judgment based on the facts and circumstances.

FOLLOW THE FOUR-STEP SEQUENCE TO IDENTIFY WHETHER ANY PARTY HAS POWER

As discussed above, steps to identifying the party with power are as follows:

- Step 1: Analyze the nature of the risks in the VIE (see Section 2.2.1)
- Step 2: Determine the VIE's purpose and the variability it is designed to create and pass along to its interest holders (see Section 2.2.2)
- Step 3: Identify the significant activities (see Section 3.3.2.1)
- Step 4: Determine how decisions are made

A common pitfall when determining which party has power is to jump to the fourth step and review the list of rights held by each party according to the VIE's governing documents. That approach often includes irrelevant information (such as rights that do not relate to directing the activities that most significantly impact the VIE's economic performance) and omits important information about activities governed through other arrangements. It can also result in incorrect conclusions because an activity that significantly impacts the economic performance for one legal entity may not be significant for another, depending on each entity's purpose and design.

Determining which party directs the activities that most significantly impact the VIE's economic performance requires the application of professional judgment based on the facts and circumstances. Performing the four steps in order is particularly important when determining whether power is shared or whether the parties share decision-making rights over some (but not all) significant activities. A misstep may affect the conclusion about which party (if any) has power and therefore the identification of the primary beneficiary.

SEC staff speeches highlight the importance of appropriately identifying the party with power and common pitfalls.

SEC STAFF GUIDANCE

Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments

Paul A. Beswick, Deputy Chief Accountant

> *First regarding 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 impacts 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.*

SEC STAFF GUIDANCE

[Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments]

Wesley R. Bricker, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *Activities of a Variable Interest Entity*
>
> *The first area [of observations by the SEC staff] pertains to identifying the scope and duration of the variable interest entity's activities that are significant to the entity's economic performance. Why is this 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.*
>
> *Power to Direct the Activities*
>
> *The second area pertains to identifying which party or parties have power to direct the activities of a variable interest entity.*
>
> *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.*
>
> *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.*

4.2.1 Implied Power — A Misconception

FASB REFERENCES

ASC 810-10-15-13A through 15-13B and ASC 810-10-25-38F through 25-38G

When evaluating whether a reporting entity has power, it is important to consider its involvement with the design of a VIE. Although not determinative, if a reporting entity was involved with designing a VIE, it may have had the opportunity and incentive to obtain the power to direct the activities that most significantly impact the VIE's economic performance. A reporting entity has a greater incentive to obtain power as its economic exposure increases.

When a reporting entity's economic exposure to a VIE is disproportionately greater than its stated power, skepticism is warranted. Although economics are not determinative, a reporting entity's economics may indicate the amount of power the reporting entity holds.

BDO INSIGHTS — DETERMINING WHETHER TERMS AND AGREEMENTS ARE SUBSTANTIVE

Skepticism should increase when a party is exposed to most of the economics from a VIE but does not have power, especially when other parties involved with the VIE are related parties or de facto agents. Understanding why the parties agreed to such an arrangement is important. However, ASC 810 does not contemplate the notion of implied power (also referred to as "implicit power" or "de facto control"). Therefore, it is important to balance professional skepticism with an understanding of the contractual arrangements. A reporting entity must evaluate the substance of the arrangements when power and economics are disproportionate, considering the VIE's purpose and design.

Evaluating the substance of arrangements can be difficult, particularly when power and economics are disproportionate and the reporting entity was significantly involved in designing the VIE. In those situations, it is important to consider:

- The economic and business purpose and design of terms and arrangements (see Section 2.2.2.2)
- The ways in which terms and arrangements vary from what is typical in the industry or from the other similar arrangements involving the reporting entity
- The parties' economic motivations and relationships with each other
- The legal enforceability of terms and provisions

When obtaining an understanding of the substance of the arrangements, a reporting entity should consider:

- Why the party with most of the economic exposure is "giving away" decision-making rights to another party
- Whether the arrangement has been closely analyzed for terms and conditions that create a related-party (or de facto agency) relationship
- Whether fees paid to a decision maker are variable interests:
  - Whether services or terms are new or unique (which requires more judgment when evaluating such terms)
  - Whether common terms or features are missing (which might indicate that an implicit variable interest exists)
  - Whether the fees are determined in a way that indirectly exposes the decision maker to risk of loss

- Whether terms and conditions in the final structure substantively differ from what was originally negotiated or presented (changes might give insight into the parties' expectations or economic motivations)
- Whether negative consequences would arise if a different accounting conclusion were reached (being aware of such consequences helps to identify why the VIE was designed in this manner)

We believe written terms and arrangements generally are substantive. However, identifying unusual or inconsistent aspects of terms and arrangements is important. Determining whether stated power is substantive requires the application of professional judgment based on the facts and circumstances, as discussed by the SEC staff.

SEC STAFF GUIDANCE

Remarks before the 2014 AICPA Conference on Current SEC and PCAOB Developments

Christopher F. Rogers, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *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? 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.*
>
> *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. 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.* [Footnotes omitted.]

4.2.2 Single Decision Makers and Rights Held by Others

FASB REFERENCES

ASC 810-10-20: Decision Maker, Kick-out Rights (VIE Definition), Participating Rights (VIE Definition), and ASC 810-10-25-38C

In ASC 810, a decision maker is "*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*" (that is, the significant activities). Decision-making rights can arise through different instruments or arrangements, including equity at risk. A party might contractually have the right to make decisions because it holds, for example:

- A majority voting interest
- A general partnership interest in a limited partnership
- A managing member interest in an LLC
- A role as an operator, manager, or significant service provider

If the decision maker does **not** have a variable interest, it does not have power and it cannot be the primary beneficiary (see Section 3.3.2). If the single decision maker has economics, it is the primary beneficiary unless a single party (including its related parties and de facto agents) holds substantive kick-out rights or participating rights. When identifying the primary beneficiary, the VIE definitions of kick-out rights and participating rights apply regardless of whether the VIE is a corporation or limited partnership.

	VIE DEFINITIONS
Kick-Out Rights	*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.* (See Section 3.3.2.2).
Participating Rights	*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.* (See Section 3.3.2.3).

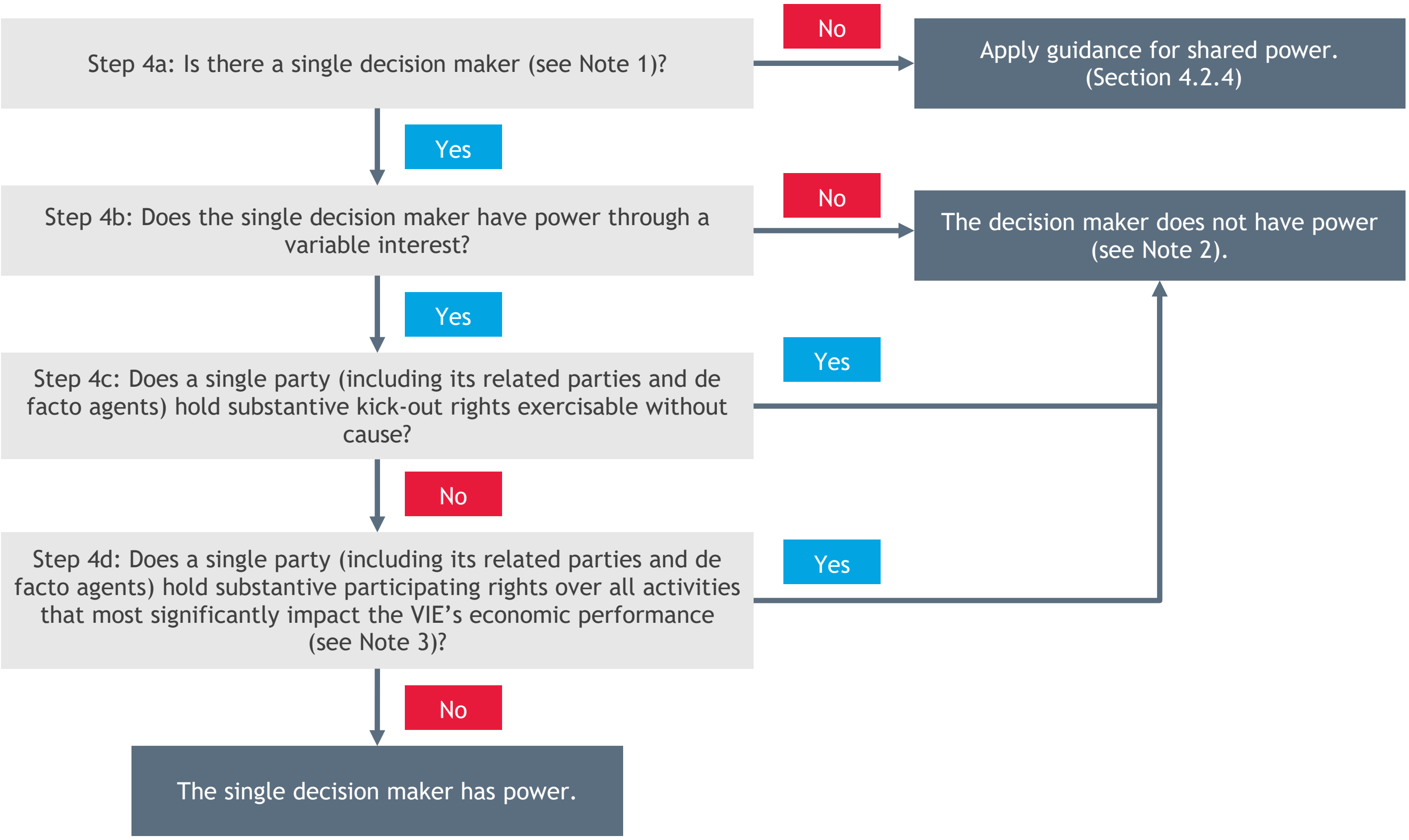
Kick-out rights and participating rights must be substantive (see Section 3.3.4) and exercisable to be considered in the analysis of whether a single decision maker has power.

BDO INSIGHTS — DETERMINING WHETHER A PARTY IS A SINGLE DECISION MAKER

Not every party with delegated authority to make decisions on behalf of a VIE meets the definition of a single decision maker. As defined in ASC 810, a decision maker is a party with the power to direct the activities that most significantly impact the VIE's economic performance.

A party with **other** delegated decision-making rights (that is, rights to make decisions about activities that do **not** significantly impact the VIE's economic performance) is **not** a single decision maker. See Section 3.3.2.1 for guidance on this determination.

This flowchart demonstrates how to evaluate the effect of substantive kick-out rights and participating rights when determining which party (if any) has power over a VIE (as part of Step 4: Determine how decisions are made).



- **Note 1:** See Section 4.2.3 for guidance when there appear to be multiple decision makers. One of these parties generally is identified as the single decision maker.
- **Note 2:** If a single party holds substantive kick-out rights over a decision maker, we believe that party generally has power unless it cannot unilaterally replace the decision maker.
- **Note 3:** If a single party (unrelated to the decision maker) holds substantive participating rights over decisions about **all** activities that most significantly impact the VIE's economic performance, no party has power (see Section 4.2.2.2), and the parties share power (see Section 4.2.4). If a single party holds substantive participating rights over decisions about **some** (but not all) of the activities that most significantly impact the VIE's economic performance, the single decision maker still has power (see Section 4.2.2.2).

A single decision maker without a variable interest cannot be the primary beneficiary (and therefore does not control or consolidate the VIE), as discussed above and by the SEC staff.

SEC STAFF GUIDANCE

Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments

Christopher D. Semesky, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *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 my example, if the manager determines that its fee is not a variable interest the [requirements of ASC 810] 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. [Footnotes omitted.]

4.2.2.1 Kick-Out Rights

FASB REFERENCES

ASC 810-10-25-38C

When identifying the primary beneficiary, if a **single party** (including its related parties and de facto agents) holds a substantive kick-out right exercisable without cause, the single decision maker does not have power over the VIE (as shown in the graphic below). In this context, a single decision maker is a party that makes decisions about the activities that most significantly impact a VIE's economic performance through **any** variable interest, including through equity at risk (not just a party that makes decisions through a contractual arrangement and receives a fee). See Section 3.3.2.2 for guidance on kick-out rights.

Exercisable by a single party (including its related parties and de facto agents) + Exercisable without cause (Section 3.3.2.2) + Substantive (Section 3.3.4.1) = Prevents the single decision maker from having power

BDO INSIGHTS — EVALUATING THE EFFECT OF KICK-OUT RIGHTS WHEN IDENTIFYING THE PARTY WITH POWER

We believe when a single party holds a substantive kick-out right exercisable without cause, that party generally has power over the VIE unless it cannot unilaterally replace the decision maker. We also believe that a board of directors is not a single party when evaluating whether a single party holds a substantive kick-out right unless a single party controls the board.However, reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

KICK-OUT RIGHTS ARE TREATED DIFFERENTLY WHEN IDENTIFYING THE PRIMARY BENEFICIARY

When identifying the primary beneficiary, **a single party** (including its related parties and de facto agents) must hold substantive kick-out rights to prevent a single decision maker from having power. This evaluation differs from the treatment of kick-out rights when determining whether a legal entity is a VIE. In that evaluation, substantive kick-out rights must be exercisable by **a simple majority or lower threshold** of limited partners with equity at risk to conclude that a limited partnership does not have the power characteristic of a VIE (see Section 3.3.3.1).

See Section 4.6 for more examples in which a single decision maker has a variable interest.

EXAMPLE 4-1: KICK-OUT RIGHTS

FACTS

- A retailer, a strategic equity investor, and a lender formed a legal entity to sell goods to customers in a new country.
- The legal entity has insufficient equity at risk, so it is a VIE (see Section 3.2).
- The retailer manages the VIE's operations through a service agreement that gives it the right to make decisions about the activities that most significantly impact the VIE's economic performance, which are:
  - Determining the VIE's sales and marketing strategy
  - Setting the VIE's annual budget (which includes purchasing decisions)
- The retailer receives fees for its services, which are variable interests (see Section 2.3.8).
- The strategic equity investor can remove and replace the retailer as the decision maker without cause, and there are no significant barriers to exercising this right (see Section 3.3.4.1).

CONCLUSION

The retailer does not have power; the strategic equity investor has power.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (including sales volume risk, retail price risk, inventory price risk, and other operating cost risks).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along operations risk to its interest holders, enable the investors to extend their presence into a new country, and earn a return for the retailer, strategic equity investor, and lender on their investments.
- Step 3: Identify the significant activities.
  - Determining the VIE's sales and marketing strategy.
  - Setting the VIE's annual budget (including purchasing decisions).
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The retailer is the single decision maker because it has the right to make decisions about the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The retailer's decision-making rights come through its fees, which are variable interests.
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? Yes. The strategic equity investor (a single party) has the unilateral right to remove and replace the retailer as decision maker. The kick-out right is exercisable without cause and there are no significant barriers to exercising it. Therefore, the retailer does not have power; the strategic equity investor has power.

4.2.2.2 Participating Rights

FASB REFERENCES

ASC 810-10-20: Participating Rights (VIE Definition) and Protective Rights (VIE Definition), and ASC 810-10-25-38C

When identifying the primary beneficiary, the reporting entity determines whether there is a single decision maker, and if so, whether a single party (including its related parties and de facto agents) holds substantive participating rights over **all** the decisions about the activities that most significantly impact a VIE's economic performance.

In this context, a single decision maker is a party that makes decisions about the activities that most significantly impact a VIE's economic performance through **any** variable interest, including through equity at risk (not just a party that makes decisions through a contractual arrangement and receives a fee).

To determine whether a right is a substantive participating right, the reporting entity first determines whether that right allows the holder to participate in (or veto) decisions about the activities that most significantly impact the VIE's economic performance, which depends on the VIE's purpose and design (see Section 2.2.2.2). A right that relates to an activity that does **not** significantly impact the VIE's economic performance is a protective right and does not prevent a single decision maker from having power. See Section 3.3.2.3 for guidance on participating and protective rights.

If the right is participating, the reporting entity then determines whether that right is substantive (see Section 3.3.4.2). Substantive participating rights held by a single party (including its related parties and de facto agents) are then evaluated further:

- If the single decision maker directs **all** activities that most significantly impact the VIE's economic performance through a variable interest, and a single party (including its related parties and de facto agents) holds substantive participating rights over **some** of the significant activities, the single decision maker has power (see Example 4-2).
- If a single party (including its related parties and de facto agents) holds substantive participating rights over **all** the significant activities, the single decision maker does **not** have power over the VIE.

  Exercisable by a single party (including its related parties and de facto agents) + Substantive (Section 3.3.4.2) = Prevents the single decision maker from having power

  In this situation:

  - If the parties are **not** related parties or de facto agents, and the party with the substantive participating right has a variable interest, no party has power (see Example 4-3).
  - If the parties are **not** related parties or de facto agents, and the party with the substantive participating right does not have a variable interest, reaching a conclusion requires the application of professional judgment based on the facts and circumstances.
  - If the parties are members of a related party group (including de facto agents) that collectively has the characteristics of a primary beneficiary (that is, power and economics), they share power (see Section 4.2.4) and would perform the related party tiebreaker (see Section 4.4.2).

BDO INSIGHTS — WHEN APPROVAL CANNOT BE UNREASONABLEY WITHHELD

A party may have the right to approve decisions about the activities that most significantly impact the VIE's economic performance, but such approval cannot be unreasonably withheld. We believe it is inappropriate to assume the party will not withhold its approval, because such a clause is subjective and may not prevent exercise of the approval right. Reaching a conclusion about the substance of the right requires the application of professional judgment based on the facts and circumstances and may require the assistance of legal counsel.

PARTICIPATING RIGHTS ARE TREATED DIFFERENTLY WHEN IDENTIFYING THE PRIMARY BENEFICIARY

When identifying the primary beneficiary, a single party (including its related parties and de facto agents) must hold substantive participating rights over decisions about **all** activities that most significantly impact the legal entity's economic performance to prevent the single decision maker from having power.

This evaluation differs from the treatment of participating rights when determining whether a legal entity is a VIE and evaluating whether the holders of the equity at risk collectively lack the power to direct the activities that most significantly impact the legal entity's economic performance. In the VIE determination:

- For a corporation, if one or more variable interest holders other than the holders of the equity at risk has substantive kick-out rights or **any** substantive participating rights, the holders of the equity at risk collectively lack power (the corporation is a VIE) (see Section 3.3.2.3).
- For a limited partnership, if a simple majority or lower percentage of the limited partners with equity at risk have substantive kick-out rights or limited partners with equity at risk have **any** substantive participating rights, the holders of the equity at risk collectively have power (the limited partnership is not a VIE) (see Section 3.3.3.2).

In other words, the threshold in the VIE determination (where the focus is on the existence of **any** substantive participating rights) differs from the primary beneficiary identification (where the focus is on having substantive participating rights over decisions about **all** activities that most significantly impact the VIE's economic performance).

Examples 4-2 and 4-3 illustrate the guidance in this section. At the 2019 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff also discussed an investment fund and the evaluation of the limited partner's rights.

EXAMPLE 4-2: PARTICIPATING RIGHTS OVER ONE SIGNIFICANT ACTIVITY

FACTS

- A retailer, a strategic equity investor, and a lender formed a legal entity to sell goods to customers in a new country.
- The legal entity has insufficient equity at risk, so it is a VIE (see Section 3.2).
- The retailer manages the VIE's operations through a service agreement that gives it the right to make decisions about the activities that most significantly impact the VIE's economic performance, which are:
  - Determining the VIE's sales and marketing strategy.
  - Setting the VIE's annual budget.
- The retailer receives fees for its services, which are variable interests (see Section 2.3.8).
- The strategic equity investor has the unilateral right to veto the annual budget, except as it relates to the VIE's sales and marketing strategy. There are no significant barriers to exercising this right (see Section 3.3.4.2).
- The lender has the unilateral right to veto a decision by the VIE to file for bankruptcy, and there are no significant barriers to exercising this right.

CONCLUSION

The retailer has power because it has the unilateral right to direct one of the activities that most significantly impacts the VIE's economic performance.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (including sales volume risk, retail price risk, inventory price risk, and other operating cost risks).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along operations risk to its interest holders, enable the investors to extend their business into a new country, and earn a return for the retailer, strategic equity investor, and lender on their investments.
- Step 3: Identify the significant activities.
  - Determining the VIE's sales and marketing strategy.
  - Setting the VIE's annual budget.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The retailer has right to make decisions about the sales and marketing strategy, which is not constrained by the strategic investor's right to veto the annual budget. The retailer is a single decision maker because it has the right to make decisions about one of the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The retailer's decision-making rights come through its service (fee) arrangement, which is a variable interest.
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No.
    - The strategic equity investor has the unilateral right to veto the annual budget (except as it relates to the sales and marketing strategy), which is one of the activities that most significantly impacts the VIE's economic performance. Therefore, the strategic equity investor holds a substantive participating right over one (but not all) of the activities that most significantly impacts the VIE's economic performance.
    - Effectively, the retailer unilaterally directs one significant activity, and the retailer and strategic equity investor share decision-making rights over the other significant activity.
    - Because the strategic equity investor holds a substantive participating right over decisions about only one (not all) of the activities that most significantly impact the VIE's economic performance, the retailer has power over the VIE.
    - The lender's unilateral right to veto a decision by the VIE to file for bankruptcy is irrelevant because it does not relate to an activity that most significantly impacts the VIE's economic performance and therefore is protective.

EXAMPLE 4-3: PARTICIPATING RIGHTS OVER ALL SIGNIFICANT ACTIVITIES

FACTS

- Assume the same facts as in Example 4-2, except the strategic equity investor has the unilateral right to veto **all** decisions about the following activities (and there are no significant barriers to exercising these rights):
  - Determining the VIE's sales and marketing strategy.
  - Setting the VIE's annual budget.

CONCLUSION

The retailer does not have power over the VIE because the strategic equity investor has the right to participate in decision-making for all activities that most significantly impact the VIE's economic performance. However, if the retailer and strategic investor are related parties or de facto agents, the reporting entity performs the related party tiebreaker (see Section 4.4.2) to identify the primary beneficiary.

ANALYSIS

- Steps 1 through 3 are the same as in Example 4-2.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The retailer is a single decision maker because it has the right to make decisions about the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The retailer's decision-making rights come through its variable interest.
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? Yes. The strategic equity investor has the unilateral right to veto all decisions about determining the sales and marketing strategy and setting the annual budget. Therefore, the strategic equity investor holds participating rights over all activities that most significantly impact the VIE's economic performance. Further, there are no significant barriers to exercising these veto rights.
    - If the retailer and strategic equity investor are not related parties or de facto agents, no party has power; the retailer and the strategic equity investor share power (see Section 4.2.4).
    - If the retailer and strategic equity investor are related parties or de facto agents, the reporting entity performs the related party tiebreaker (see Section 4.4.2) to identify the primary beneficiary.
    - The lender's right to veto a decision by the VIE to file for bankruptcy is irrelevant because it does not relate to an activity that significantly impacts the VIE's economic performance, so it is protective.

4.2.2.3 Decisions Made by Majority Vote

FASB REFERENCES

ASC 810-10-25-38A

Sometimes the decisions about the activities that most significantly impact the VIE's economic performance are made by a majority vote; for example, by a board of directors elected by equity holders. In such cases:

- If one party holds a majority voting interest through a variable interest, that party has power unless another single party holds substantive kick-out rights (see Section 4.2.2.1) or participating rights (see Section 4.2.2.2).
- If no party has a majority voting interest, no party individually has power. If the parties are not related parties or de facto agents, no party controls the VIE. However, if a related party group (including de facto agents) collectively has the characteristics of a primary beneficiary (power and economics), the related party guidance applies (see Section 4.4).

BDO INSIGHTS — DE FACTO CONTROL DOES NOT EXIST IN U.S. GAAP

In IFRS, de facto control is the ability to make decisions with less than a majority of votes based on the relative size of the voting rights and an analysis of historical voting patterns. For example, under IFRS, a party might have de facto control if it holds 49% of the votes, and the other voters are widely dispersed and rarely vote. While de facto control can result in control in accordance with IFRS, the concept does not exist in U.S. GAAP.

In U.S. GAAP, to control a VIE, a reporting entity must have the substantive contractual right to make decisions about the activities that most significantly impact the legal entity's economic performance. Therefore, the dispersion of voting rights and historical voting patterns are irrelevant. However, in these situations, it is critical to identify all variable interests (including implicit variable interests, as discussed in Section 2.6) and all substantive terms and arrangements (as discussed in Section 4.2.1), to determine whether stated power is substantive.

More information on control and consolidation under IFRS is available here.

4.2.3 Multiple Decision Makers

FASB REFERENCES

ASC 810-10-25-38D through 25-38E

Sometimes multiple decision makers direct the activities that most significantly impact the VIE's economic performance.

Many fact patterns are mistaken for shared power, but shared power exists only when two or more parties must unanimously consent or agree to make decisions about **all** activities that most significantly impact the VIE's economic performance (see Section 4.2.4).

When multiple decision makers do not share power, the analysis of which party has power depends on whether the parties direct the same significant activities (see Section 4.2.3.1) or different significant activities (see Section 4.2.3.2).

4.2.3.1 Parties Direct the Same Significant Activities

FASB REFERENCES

ASC 810-10-25-38D and ASC 810-10-55-182 through 55-196

When multiple parties direct the **same** activities that most significantly impact the VIE's economic performance, the party, if any, with the right to direct the **majority** of those activities has power and is considered the single decision maker. Example 4-4 illustrates this determination.

EXAMPLE 4-4 (ADAPTED FROM ASC 810-10-55-182 THROUGH 55-196): TWO PARTIES DIRECT THE SAME SIGNIFICANT ACTIVITIES

FACTS

- Investor A and Investor B (which are not related parties or de facto agents) formed a VIE to manufacture, distribute, and sell beverages.
- Investor A and Investor B each hold 50% of the VIE's equity.
- Investor A and Investor B each have decision-making rights for the VIE's manufacturing, distribution, and selling activities in separate locations, and decisions about these activities (which are the activities that most significantly impact the VIE's economic performance) do **not** require the unanimous consent of Investor A and Investor B. In other words, the investors unilaterally direct the same activities, but in different locations.

CONCLUSION

Whichever of Investor A or Investor B has power over the majority of the activities that most significantly impact the VIE's economic performance is the single decision maker. Determining which party directs the majority of the activities requires the application of professional judgment based on the facts and circumstances.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (from manufacturing, distributing, and selling beverages in two separate locations).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along operations risk to its interest holders.
- Step 3: Identify the significant activities.
  - Manufacturing, distributing, and selling the beverages.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes; however, further analysis is required to identify which investor is the single decision maker. Decisions about the activities that most significantly impact the VIE's economic performance do **not** require the unanimous consent of Investor A and Investor B, so they do not share power. Whichever of Investor A or Investor B has the right to direct the **majority** of the activities that most significantly impact the VIE's economic performance has power and is considered to be the single decision maker. For example, if Investor A were determined to direct the majority of the activities that most significantly impact the VIE's economic performance, Investor A would be considered the single decision maker. (The reporting entity would then perform the rest of Step 4).

For variations on this fact pattern, see:

- Example 4-5: Two parties direct different significant activities.
- Example 4-8: Two parties that are not related parties or de facto agents share power.
- Example 4-9: Two parties must agree on some, but not all, significant activities.
- Example 4-19: Two parties that are related parties or de facto agents share power.

4.2.3.2 Parties Direct Different Significant Activities

FASB REFERENCES

ASC 810-10-25-38E and ASC 810-10-55-182 through 55-198

When multiple parties direct different activities that significantly impact the VIE's economic performance, the party with the right to direct the activities that most significantly impact the VIE's economic performance is the single decision maker and has power.

When some of the activities that most significantly impact the VIE's economic performance are completed in phases or are contingent on successfully completing the first set of activities, determining which party is the single decision maker and has power requires the application of professional judgment based on the facts and circumstances (see Section 4.2.3.3).

Example 4-5 illustrates the evaluation when multiple parties direct different activities that significantly impact the VIE's economic performance that are not completed in phases or contingent on completing the first set of activities.

EXAMPLE 4-5 (ADAPTED FROM ASC 810-10-55-182 THROUGH 55-193): TWO PARTIES DIRECT DIFFERENT SIGNIFICANT ACTIVITIES

FACTS

- Investor A and Investor B (which are not related parties or de facto agents) formed a VIE to manufacture, distribute, and sell beverages.
- Investor A and Investor B each hold 50% of the VIE's equity.
- Investor A has decision-making rights for the VIE's manufacturing activities.
- Investor B has decision-making rights for the VIE's distribution and selling activities.
- Therefore, decisions about manufacturing, distributing, and selling the beverage (which are the activities that most significantly impact the VIE's economic performance) do **not** require the unanimous consent of Investor A and Investor B.

CONCLUSION

Whichever of Investor A or Investor B has the power to direct the activities that **most** significantly impact the VIE's economic performance (that is, manufacturing, or distributing and selling) is the single decision maker. Reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (from manufacturing, distributing, and selling beverages).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along operations risk to its interest holders.
- Step 3: Identify the significant activities.
  - Manufacturing, distributing, and selling the beverages.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. Decisions about the activities that most significantly impact the VIE's economic performance do not require the unanimous consent of Investor A and Investor B, so they do not share power. Investor A directs the manufacturing activities, while Investor B directs distributing and

selling activities. Investor A or Investor B is the single decision maker, depending on which investor has the right to direct the activities that **most** significantly impact the VIE's economic performance. The reporting entity would determine whether the manufacturing activities (directed by Investor A) or the distributing and selling activities (which are considered collectively because they are both directed by Investor B) most significantly impact the VIE's economic performance and then perform the rest of Step 4.

For variations on this fact pattern, see:

- Example 4-4: Two parties direct the same significant activities.
- Example 4-8: Two parties that are not related parties or de facto agents share power.
- Example 4-9: Two parties must agree on some, but not all, significant activities.
- Example 4-19: Two parties that are related parties or de facto agents share power.

During the 2019 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff discussed another fact pattern regarding a lessor legal entity in which multiple parties direct different activities that significantly impact the VIE's economic performance.

4.2.3.3 Parties Direct Significant Activities in Phases or Depending on a Contingent Event

FASB REFERENCES

ASC 810-10-25-38E and ASC 810-10-55-104

In some cases, parties have different decision-making rights during different phases of a VIE's life. For example, one party may have decision-making rights over significant activities during one phase (such as constructing an asset or R&D for a drug), and another party may have decision-making rights over significant activities during a later phase (such as operating the constructed asset) or upon a contingent event (such as manufacturing and distributing a drug upon approval from the Food and Drug Administration (FDA)).

When parties direct different activities that most significantly impact the VIE's economic performance, one party is identified as the single decision maker and has power. A party's right to direct the activities that most significantly impact the VIE's economic performance when circumstances arise, or an event happens, gives that party power.

BDO INSIGHTS — PURPOSE AND DESIGN AFFECTS THE EVALUATION OF PHASES AND CONTINGENCIES

If decision-making rights depend on moving between phases or upon a contingent event, the reporting entity must analyze the VIE's purpose and design to determine which party has decision-making rights over the activities that most significantly impact the VIE's economic performance. Reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

When performing this analysis, we believe that the more likely it is that the VIE will move to its next planned phase or that a contingent event will occur, the more likely that it would be appropriate to include the decision-making rights that will be present in the next phase or triggered upon the contingent event when determining which party has power, as shown in this graphic.

For example, if the phase 2 or contingent decision-making rights depend on activities in phase 1, the analysis considers the likelihood that the phase 2 or contingent decision-making rights will become exercisable.

- If there is a **high** likelihood that the phase 2 or contingent decision-making rights will become exercisable, it would likely be appropriate to include the activity that will be governed by those rights in the power assessment. The reporting entity would determine which activities (those in phase 1 or 2) most significantly impact the VIE's economic performance. The party with decision-making rights about those activities would be the single decision maker, even if its decision-making rights are not triggered until moving to phase 2 or upon the contingent event.
- If there is a **low** likelihood that the phase 2 or contingent decision-making rights will become exercisable, it would likely be appropriate to exclude the activity that will be governed by those rights in the power assessment. The reporting entity would likely determine that the party with decision-making rights over the phase 1 (or noncontingent significant activities) would be the single decision maker, until moving to phase 2 or upon the contingent event. At that point, the reporting entity would reassess which party has decision-making rights over the significant activities.

However, this analysis depends on the facts and circumstances, including the VIE's purpose and design. The type of contingent event discussed herein is an event that is planned, expected, or contemplated as part of the VIE's purpose and design. In contrast, a contingent event that is not part of the VIE's purpose and design (for example, a loan default or filing for bankruptcy) generally is not considered until it occurs. Upon such a contingent event or change in facts and circumstances, the reporting entity would reassess which party is the single decision maker in its ongoing assessment of the primary beneficiary (see Section 4.5).

Examples 4-6 and 4-7 illustrate the power evaluation when different parties direct significant activities during separate phases or depending on a contingent event, but the examples are not determinative. Reaching a conclusion in a real fact pattern requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 4-6: TWO PARTIES DIRECT DIFFERENT ACTIVITIES — UNLIKELY CONTINGENT EVENT

FACTS

- Investor A and Investor B formed a VIE to research and develop an early-stage drug candidate and manufacture and distribute that drug if it receives FDA approval.
- Investor A and Investor B are not related parties or de facto agents.
- Through its equity at risk, Investor A has decision-making rights over R&D for the drug candidate, which is the activity that most significantly impacts the VIE's economic performance during the current phase. Investor B does not have kick-out rights or participating rights for this activity.
- If the FDA approves the drug candidate, Investor B has decision-making rights about manufacturing and distributing the drug, which would be the activities that would most significantly impact the VIE's economic performance upon approval.
- As of the evaluation date, the investors believe there is significant uncertainty about whether the FDA will approve the drug candidate, given its early stage and the difficulties of achieving success.

CONCLUSION

Investor A is the single decision maker and has power over the VIE as of the evaluation date. However, reaching a conclusion requires the application of professional judgment based on the facts and circumstances and requires ongoing assessment.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (from R&D and manufacturing and distributing the drug if approved by the FDA).

- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is create and pass along operations risk to its interest holders.
- Step 3: Identify the significant activities.
  - R&D for an early-stage drug candidate (phase 1).
  - Manufacturing and distributing the drug (phase 2, which is contingent on FDA approval). However, because there is significant uncertainty about whether the FDA will approve the drug candidate, the manufacturing and distribution activities are excluded when identifying which party has power over the VIE.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. A has unilateral decision-making rights over R&D (which is the only activity that most significantly impacts the VIE's economic performance considered in the current evaluation) and is therefore the single decision maker.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. Investor A's decision-making rights come through its equity at risk, which is a variable interest.
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Therefore, Investor A has power.

If the FDA approves the drug candidate, the reporting entity would reassess which party is the single decision maker and has power in its ongoing assessment of the primary beneficiary (see Section 4.5).

EXAMPLE 4-7: TWO PARTIES DIRECT DIFFERENT ACTIVITIES — HIGHLY LIKELY CONTINGENT EVENT

FACTS

- Investor A and Investor B (which are not related parties or de facto agents) formed a VIE to construct a residential building, which will be leased to third parties and has an economic life of 40 years.
- Investor A has decision-making rights through its equity at risk for construction activities, which is one of the activities that most significantly impacts the VIE's economic performance. Investor B does not have kick-out rights or participating rights for this activity.
- Investor B has decision-making rights through its equity at risk about operating the property (including executing leases, managing credit risk, maintaining the property, and making capital expenditures) which will be the activities that most significantly impact the VIE's economic performance once construction is completed. Investor A does not have kick-out rights or participating rights for these activities.
- As of the evaluation date, based on the nature of the building being constructed, Investor A's experience, and the VIE's purpose and design, the investors believe that it is highly likely that the VIE will complete construction and move to operations.
- The decisions made by Investor B during the operations phase will more significantly impact the VIE's economic performance than the decisions made during the construction phase.

CONCLUSION

Investor B is the single decision maker for the VIE as of the evaluation date. However, reaching a conclusion requires the application of professional judgment based on the facts and circumstances and requires an ongoing assessment.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (from constructing and operating a residential building).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along operations risk to its interest holders.
- Step 3: Identify the significant activities.
  - Constructing the building (phase 1).
  - Operating the residential building (including executing leases, managing credit risk, maintaining the property, and making capital expenditures, which occur in phase 2). Although the operating activities are contingent on completing construction (phase 1), the investors believe construction is highly likely to be completed (consistent with the VIE's purpose and design). Therefore, the operating activities are included when determining which investor has power.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. When multiple parties direct different activities that significantly impact the VIE's economic performance, the party with the right to direct the activities that **most** significantly impact the VIE's economic performance is the single decision maker (see Section 4.2.3.2). Investor B has unilateral decision-making rights over the operating activities, which (of the two activities identified in Step 3) are the activities that most significantly impact the VIE's economic performance. Investor A has decision-making rights about construction activities, but operating activities will more significantly impact the VIE's economic performance, so Investor B is considered the single decision maker.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. Investor B's decision-making rights come through its equity at risk, which is a variable interest.
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Therefore, Investor B has power over the VIE.

If facts and circumstances change, the reporting entity would reassess which party is the single decision maker and has power in its ongoing assessment of the primary beneficiary (see Section 4.5).

4.2.4 Shared Power

FASB REFERENCES

ASC 810-10-25-38D and ASC 810-10-55-182 through 55-196

Shared power exists only if two or more parties must unanimously consent or agree to make decisions about **all** activities that most significantly impact the VIE's economic performance. Reaching a conclusion about whether power is shared requires the application of professional judgment based on the facts and circumstances.

- When parties that are not related parties or de facto agents share power, no party is the primary beneficiary (see Example 4-8).
- When related parties or de facto agents share power, the reporting entity performs the related party tiebreaker to identify the primary beneficiary (see Section 4.4.2).

FACT PATTERNS MISTAKEN FOR SHARED POWER

The following situations are often mistaken for shared power (shared power does **not** exist in these fact patterns):

- If decisions about the activities that most significantly impact the VIE's economic performance are intended to be made unanimously, but one party has a tiebreaker vote over a decision, that party has power over the VIE; the party with the tiebreaker vote is a single decision maker (see Section 4.2.2).
- If one activity that most significantly impacts the VIE's economic performance is directed unilaterally by one party, and the other significant activities are directed by unanimous consent, power is **not** shared, even if overall, decisions about that one activity are less significant to the VIE's economic performance than the activities directed by unanimous consent. Instead, the party unilaterally making decisions about the one significant activity is the single decision maker (see Section 4.2.2) and has power, assuming decision-making rights come through a variable interest (see Example 4-9).

When a general partner, managing member, operator, or similar party is involved, it is important to determine based on the facts and circumstances whether that party is only executing activities that are constrained by the decisions made by other parties to the arrangement (see Example 4-10) or whether it is unilaterally making the decisions about the activities that most significantly impact the VIE's economic performance through a variable interest. See Step 1 in Section 3.3.2.1 for guidance on this evaluation.

Examples 4-8 through 4-10 illustrate how to determine whether power is shared.

EXAMPLE 4-8 (ADAPTED FROM ASC 810-10-55-182 THROUGH 55-196): PARTIES THAT ARE NOT RELATED PARTIES OR DE FACTO AGENTS SHARE POWER

FACTS

- Investor A and Investor B (which are **not** related parties or de facto agents) formed a VIE to manufacture, distribute, and sell beverages. They each hold 50% of the VIE's equity.
- Investor A and Investor B must unanimously agree on decisions about manufacturing, distributing, and selling the beverage (which are the activities that most significantly impact the VIE's economic performance). If Investor A and Investor B cannot agree on decisions requiring unanimous consent, arbitration is required.

CONCLUSION

Investor A and Investor B share power over the VIE.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (from manufacturing, distributing, and selling beverages).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along operations risk to its interest holders.
- Step 3: Identify the significant activities.
  - Manufacturing, distributing, and selling the beverages.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? No. Investor A and Investor B must unanimously agree on decisions about the activities that most significantly impact the VIE's economic performance, so they share power. Because Investor A and Investor B are not related parties or de facto agents, no party controls the VIE.

For variations on this fact pattern, see:

- Example 4-4: Two parties direct the same significant activities.
- Example 4-5: Two parties direct different significant activities.
- Example 4-9: Two parties must agree on some, but not all, significant activities.
- Example 4-19: Two parties that are related parties or de facto agents share power.

EXAMPLE 4-9: TWO PARTIES MUST AGREE ON SOME, BUT NOT ALL, SIGNIFICANT ACTIVITIES

FACTS

- Assume the same facts as in Example 4-8, except:
  - Investor A and Investor B must unanimously agree on decisions about the VIE's manufacturing activities.
  - Investor B has decision-making rights for the VIE's distribution and selling activities.

CONCLUSION

Investor B is the single decision maker.

ANALYSIS

- Steps 1 through 3 are the same as in Example 4-8.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. Decisions about two of the activities that most significantly impact the VIE's economic performance (distribution and selling) do not require the unanimous consent of Investor A and Investor B; instead, Investor B has unilateral decision-making over those activities. Therefore, Investor B is the single decision maker and power is not shared, even if decisions about the manufacturing activities were more significant to the VIE's economic performance than distribution and selling activities. (The reporting entity would then perform the rest of Step 4).

For variations on this fact pattern, see:

- Example 4-4: Two parties direct the same significant activities.
- Example 4-5: Two parties direct different significant activities.
- Example 4-8: Two parties that are not related parties or de facto agents share power.
- Example 4-19: Two parties that are related parties or de facto agents share power.

EXAMPLE 4-10: MANAGING MEMBER OR OPERATOR THAT IS CONSTRAINED — NOT RELATED PARTIES OR DE FACTO AGENTS

FACTS

- Investor A and Investor B (which are not related parties or de facto agents) formed a VIE to own a residential building, which is leased to third parties and has an economic life of 40 years.
- Investor A and Investor B must unanimously agree on all decisions about the activities that most significantly impact the VIE's economic performance.

- Investor A also is the VIE's managing member (or operator) and as part of that role, executes decisions and oversees the VIE's daily operations. However, the unanimously agreed decisions substantively constrain how Investor A executes those decisions and its oversight responsibilities as managing member (or operator).

CONCLUSION

Investor A and Investor B share power over the VIE.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (from owning a residential building leased to third parties).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along operations risk to its interest holders.
- Step 3: Identify the significant activities.
  - Executing leases, managing credit risk, maintaining the property, and making capital expenditures.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? No. Investor A manages the VIE's daily operations, but it must act within the constraints of decisions made unanimously by Investor A and Investor B, so Investor A is not a single decision maker. All activities that most significantly impact the VIE's economic performance are subject to unanimous consent, so Investor A and Investor B share power. Because Investor A and Investor B are not related parties or de facto agents, neither controls the VIE.

The SEC staff has discussed shared power (or lack thereof).

SEC STAFF GUIDANCE

Remarks before the 2014 AICPA Conference on Current SEC and PCAOB Developments

Christopher F. Rogers, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *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. 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. 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. 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. 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. 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. [Footnotes omitted.]

4.2.5 Potential Voting Rights (Options and Similar Instruments) When Identifying the Party With Power

Options, forward contracts, and convertible instruments to acquire a VIE's equity may give the holder the right to make decisions about the activities that most significantly impact the VIE's economic performance after they are exercised or become effective. ASC 810 does not explicitly address how to evaluate these potential voting rights when identifying whether any party has power over a VIE.

BDO INSIGHTS — POTENTIAL VOTING RIGHTS GENERALLY DO NOT CONVEY CURRENT POWER

When determining whether any party has power over a VIE, we believe a reporting entity should consider the presence of options or similar instruments (such as forwards and convertible instruments) that would give the holder the right to direct the activities that most significantly impact the VIE's economic performance upon exercise or conversion. The reporting entity should consider all facts and circumstances, including:

- The VIE's purpose and design, including why the potential voting rights were provided or obtained
- Whether the potential voting rights are exercisable currently or at a future date
- Whether the potential rights are exercisable for nominal consideration, at a fixed price, or at fair value

We believe a right to obtain power at a future date (for example, a forward to acquire equity interests at a future date or an option that is not currently exercisable) generally does **not** currently give the holder of that right power and therefore does not currently prevent another party from having power. Rather, we believe the reporting entity generally would reconsider its identification of the primary beneficiary when the potential voting right becomes effective.

However, in some cases, a potential voting right might be an in-substance kick-out right that gives the holder of that right power. For example, this might be the case when a party holds a call option that is currently exercisable and is either deep in-the-money or is exercisable for a nominal amount.

Reaching a conclusion about whether a potential voting right gives the holder power requires the use of professional judgment based on the facts and circumstances.

4.3 ECONOMICS

FASB REFERENCES

ASC 810-10-25-38A(b)

To be the primary beneficiary, the reporting entity must have **economics** that could potentially be significant to the VIE. Unlike power, which can be held by only one party, more than one party often has economics.

Economics

Economics is the obligation to absorb the VIE's losses or right to receive benefits from the VIE that **could** potentially be significant to the VIE.

Significant differences exist between the evaluation of economics when identifying the primary beneficiary of a VIE and the consideration of variability in other aspects of the VIE model.

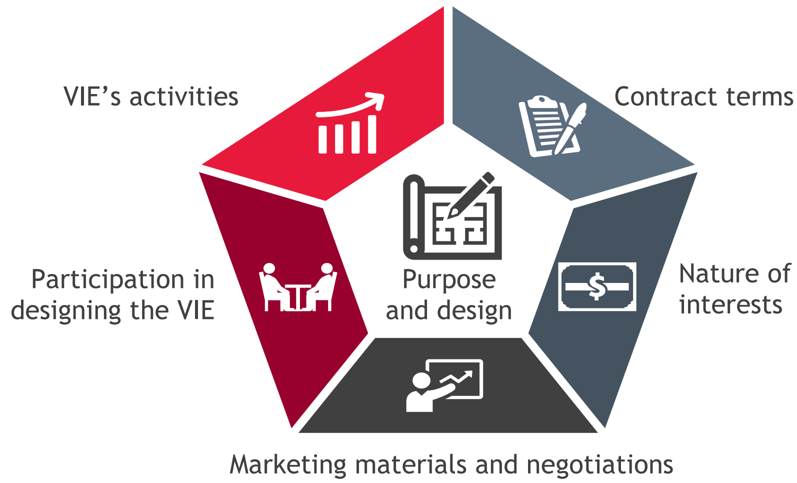
IDENTIFYING THE PRIMARY BENEFICIARY	VS	OTHER ASPECTS OF THE VIE MODEL
A party must have the obligation to absorb the VIE's losses **or** the right to receive benefits from the VIE; it does not need both. For example, a guarantee on a VIE's debt (which generally absorbs only losses) or a fixed-price purchase option on a single-asset VIE (which might absorb only benefits) could both be sources of economics.		▶ For equity to be at risk, it must participate significantly in profits **and** losses (see Section 3.2.2.1). ▶ For a legal entity to be a voting interest entity (not a VIE), the equity at risk holders must have the obligation to absorb the legal entity's expected losses **and** the right to receive the legal entity's expected residual returns (see Sections 3.4 and 3.5, respectively).
The reporting entity considers all scenarios in which the losses or benefits **could** potentially be significant to the VIE. A reporting entity considers all **possible** outcomes when identifying the primary beneficiary.		When evaluating whether decision-maker fees are variable interests, the reporting entity determines whether other interests held by the decision maker or its related parties or de facto agents **would** absorb more than an insignificant amount of the VIE's expected variability (see Section 2.3.8.2). A reporting entity considers the **probability** of expected outcomes over the legal entity's life when identifying variable interests.

When evaluating economics, the phrase "*would absorb more than an insignificant amount of expected variability*" in ASC 810-10-25-38A(b) is a higher threshold than "*could potentially be significant*" when evaluating fees in ASC 810-10-55-37. Therefore, a decision maker or service provider that meets the "would" threshold for identifying a variable interest also generally meets the "could" threshold for identifying the primary beneficiary.

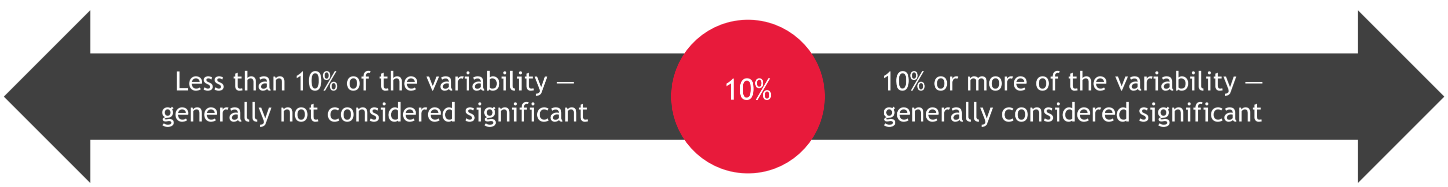
However, although a reporting entity considers all possible scenarios when evaluating economics in the identification of the primary beneficiary, it considers only those that are possible within the context of the VIE's current purpose and design. A change in the VIE's purpose and design would cause a reconsideration of whether the legal entity is a VIE and the identification of its primary beneficiary.

Determining whether a party has economics is both qualitative and quantitative. When assessing whether a party has economics, factors to consider include:

- The VIE's purpose and design, including the risks it was designed to create and pass along to its interest holders (consistent with the identification of variable interests, see Section 2.2.2.2)
- The variable interest's terms and characteristics and the nature of the variability absorbed (consistent with the identification of variable interests, see Section 2.2.2.2)
- The reasons for holding the financial interest
- The magnitude of the **variability** absorbed



When assessing whether a party's economics are significant to the VIE, ASC 810 does not provide any bright lines. However, practice has generally considered economics of 10% or more to be significant. Economics of less than 10% generally is not considered significant (unless qualitative factors suggest otherwise), as shown in the graphic.



However, **the 10% threshold is not a bright line**. The reporting entity must evaluate qualitative and quantitative factors, including the significance to the VIE of the variability absorbed by each variable interest and the priority in which variability is absorbed (see Section 4.3.1). In this evaluation, a reporting entity considers the variability in the cash flows that might be absorbed by each variable interest, which might differ from the U.S. GAAP net income that is allocated to each variable interest.

The SEC staff emphasized the importance of the qualitative evaluation of whether a party has economics.

SEC STAFF GUIDANCE

[Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments]

Paul A. Beswick, SEC Deputy Chief Accountant

> *Now I would like to turn to the second part of the evaluation of control; by that I mean the requirement to identify whether a party has an obligation to absorb losses or a right to receive benefits that could potentially be significant to the variable interest entity.*
>
> *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 and if you are having particular difficulty, please feel free to consult with the staff.

SEC STAFF GUIDANCE

Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB Developments

Arie S. Wilgenburg, Professional Accounting Fellow, SEC Office of the Chief Accountant

Power alone is not a sufficient basis for consolidation. The model requires it be combined with a significant financial interest in the entity.

So what is a significant financial interest? Well, [ASC 810] describes such an 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.

In the past few weeks, the staff has been thinking about this concept. While there is no "bright-line" set of criteria for making this assessment, I thought it would be helpful to provide some thoughts in this area.

First, 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. [Footnotes omitted]

Example 4-11 illustrates that a party needs only to have the obligation to absorb the VIE's losses **or** the right to receive benefits from the VIE to have economics. See Section 4.6 for more examples.

EXAMPLE 4-11: EVALUATING ECONOMICS IN A VIE WITH DEBT AND ONE CLASS OF EQUITY

FACTS

- Investor A and Investor B formed a VIE to develop a new product. Each contributed a small, proportionate amount of cash in exchange for 50% of the VIE's equity.
- The VIE was financed almost entirely with subordinated debt (that is, debt that is below investment-grade rated); therefore, the legal entity is a VIE because it has insufficient equity at risk (see Section 3.2).
- The equity absorbs all residual returns (which could potentially be significant to the VIE) after the debt is repaid.

CONCLUSION

The equity investors and lender all have economics.

ANALYSIS

- Each equity investor has the right to receive benefits from the VIE that **could** potentially be significant to the VIE because they each have the right to receive half the VIE's residual economics after the debt is repaid. Therefore, the equity investors have economics regardless of whether have the obligation to absorb losses that could potentially be significant to the VIE.
- The lender has the obligation to absorb losses that could potentially be significant to the VIE if the debt is not repaid, so it has economics.

4.3.1 Evaluating Economics in Complex Capital Structures

FASB REFERENCES

ASC 810-10-25-38A(b)

When determining whether a party has economics, quantitatively calculating losses and benefits is not required. Instead, the reporting entity qualitatively analyzes the terms and characteristics of the variable interests and the nature and magnitude of the variability absorbed by the variable interests. The more complex the capital structure and the more types of variable interests (absorbing different risks or absorbing risks in varying degrees of priority), the more complex the evaluation. In such cases, it generally is inappropriate to focus solely on the percentage of equity, debt, or other variable interests held by a party without considering the nature and terms of those interests and the variability absorbed by each variable interest.

BDO INSIGHTS — HORIZONTAL AND VERTICAL SLICES

A sponsor or investor in a VIE may hold a vertical or horizontal slice of debt and equity (or beneficial interests) in a VIE. These terms are often used with respect to securitizations set up to comply with risk retention rules established by regulators; however, the concepts of vertical and horizontal slices could apply to any industry.

- A horizontal slice refers to an interest in one tranche of the capital structure.
- A vertical slice refers to an interest in several (or all) tranches of the capital structure.

A party that holds a small (for example, 5%) vertical slice in each of the VIE's debt and equity tranches may be less likely to have economics than if it holds a horizontal slice of the VIE's most subordinated instrument, even if that horizontal slice represents only 5% of the VIE's total capitalization. When a party holds a horizontal slice in a subordinated instrument, it may absorb a greater proportion of the VIE's losses or benefits depending on how subordinate the interest is and the VIE's expected variability. Reaching a conclusion about whether a party has economics requires the application of professional judgment based on the facts and circumstances.

Examples 4-12 and 4-13 illustrate the evaluation of economics in more complex capital structures.

EXAMPLE 4-12: EVALUATING ECONOMICS IN A VIE WITH MULTIPLE CLASSES OF DEBT AND ONE CLASS OF EQUITY

FACTS

- An equity investor, a mezzanine lender, and a senior lender formed a VIE.
- The senior loan is investment-grade rated and therefore is not designed to have the obligation to absorb losses that could potentially be significant to the VIE.
- The mezzanine loan is designed to have the obligation to absorb the VIE's losses that could potentially be significant to the VIE (based on the size of the loan compared to other interests, the possibility of default, and the high interest rate received to compensate the mezzanine loan for that risk).
- The equity absorbs the residual returns after the senior loan and mezzanine loan are repaid.

This table shows the VIE's capitalization (on a fair value basis).

(IN MILLIONS)	FINANCING
Senior loan (investment-grade rated)	$ 15
Mezzanine loan	76
Equity	9
Total	$ 100

CONCLUSION

The equity investor and mezzanine lender each have economics, but the senior lender does not.

ANALYSIS

- The equity investor holds only 9% of the total capitalization (in a horizontal slice), but as the sole equity holder (it owns 100% of the equity interests), it has the right to receive benefits from the VIE that could potentially be significant to the VIE because it has the right to receive **all** residual returns after the senior and mezzanine loans are repaid. The equity investor also has the obligation to absorb losses that could potentially be significant to the VIE because it will absorb 100% of the VIE's losses up to its initial investment. Therefore, the equity investor has economics.

- The mezzanine lender has an obligation to absorb losses that could potentially be significant to the VIE if the mezzanine loan is not fully repaid. Therefore, the mezzanine lender has economics.
- The senior loan is investment-grade rated and has seniority over the mezzanine loan and equity; it is not designed to have the obligation to absorb losses that could potentially be significant to the VIE. Therefore, the senior lender does not have economics.

EXAMPLE 4-13: EVALUATING ECONOMICS IN A VIE WHEN EQUITY IS NOT PRO RATA (OR MULTIPLE CLASSES)

FACTS

- Investor A and Investor B formed a VIE to further develop and earn a return on an intangible asset contributed by Investor A. For its contribution, Investor received an 8% voting interest.
- Recognizing the importance of Investor A's asset, the investors agreed that Investor A will receive between 8% and 24% of the VIE's residual returns, depending on its economic performance. That is, the return on equity is not shared pro rata to the amount invested or the stated ownership percentages.

CONCLUSION

Investor A has economics.

ANALYSIS

- Even though Investor A holds only an 8% voting interest, based on the nature of the interest, its terms and characteristics, and the VIE's purpose and design, Investor A has the right to receive benefits from the VIE that could potentially be significant to the VIE.
- Regardless of Investor A's obligation to absorb the VIE's losses, because Investor A has the right to receive benefits from the VIE that could potentially be significant to the VIE, it has economics.

4.3.2 Economics Through a Subsidiary

FASB REFERENCES

ASC 810-10-25-42

When evaluating whether a party has economics, a reporting entity considers both direct and indirect interests held in a VIE. An indirect interest is one in which the party has economics through another legal entity (for example, a subsidiary or an equity method investee).

When the indirect interest is held through a related party (including de facto agents) the reporting entity does not control (for example, an equity method investee), it generally is considered proportionately (see Section 4.4.1).

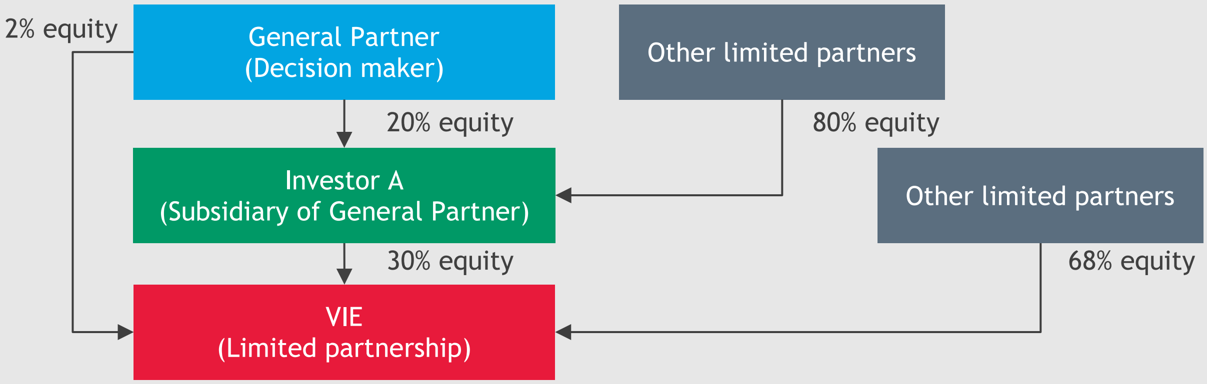
BDO INSIGHTS — EVALUATING INDIRECT INTERESTS HELD THROUGH A SUBSIDIARY

Although ASC 810 indicates that indirect interests are considered proportionately, we believe this guidance does not apply to indirect interests held through a reporting entity's subsidiary. Instead, we believe a reporting entity considers indirect interests held through its subsidiaries in their entirety (not proportionately) because the parent and subsidiary are considered a single economic entity. Evaluating indirect interests requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 4-14: EVALUATING ECONOMICS WHEN A PARENT HAS AN INDIRECT INTEREST HELD THROUGH A SUBSIDIARY

FACTS

- A general partner formed a limited partnership that is a VIE and sold partnership interests to investors (limited partners), with ownership percentages as shown. All returns are shared pro rata.
- The general partner also has a controlling financial interest in Investor A, which is a limited partner in the VIE.



CONCLUSION

The general partner has economics.

ANALYSIS

- The general partner has a 2% direct interest in the VIE. Investor A, its subsidiary, holds a 30% interest in the VIE.
- Because the general partner has a controlling financial interest in Investor A, we believe the general partner has a 32% interest in the VIE (its 2% direct interest and the 30% interest held by its subsidiary). The general partner's 32% interest in the VIE is significant, so it individually has economics.

4.3.3 Fees Paid to a Decision Maker

FASB REFERENCES

ASC 810-10-25-38H through 25-38J and ASC 810-10-55-205Z through 55-205AI

When evaluating whether a party has economics, fees paid to a decision maker or service provider are **excluded** if **all** the following conditions are met:

- The service arrangement includes only terms, conditions, and amounts **customarily** present in arrangements for similar services negotiated at arm's length (see Section 2.3.8.1).
- The fees are compensation for services provided and **commensurate** with the level of effort required to provide those services (see Section 2.3.8.1).
- The decision maker or service provider is not exposed to risk of loss (see Section 2.3.8.3).

This evaluation differs from the determination of whether decision-maker fees are variable interests. Those fees are variable interests if the decision maker has an other interest that would absorb more than an insignificant amount of the legal entity's expected variability, even if the fees are customary and commensurate and do not absorb risk of loss (see Section 2.3.8). However, when identifying the primary beneficiary and evaluating whether a decision maker has economics, it does not matter whether a decision maker has an other interest in the VIE. Decision-maker fees that are customary and commensurate and that do not absorb risk of loss are **excluded** when determining whether the decision maker has economics.

ASC 810-10-55-205Z through 55-205AI illustrate an evaluation of economics when fees are not customary and commensurate. Example 4-15 illustrates an evaluation of economics when fees **are** customary and commensurate but are variable interests as a result of other interests directly held by the decision maker. See Section 4.4.1 for guidance when the other interest is an indirect interest through a related party the decision maker does not control or through a de facto agent.

EXAMPLE 4-15: EVALUATING ECONOMICS WHEN FEES ARE CUSTOMARY AND COMMENSURATE

FACTS

- Investor A formed a VIE to which it exclusively licensed intellectual property.
- The license agreement gives Investor A the right to make all strategic and technical decisions for the VIE, which are the activities that most significantly impact the VIE's economic performance. For these services, Investor A receives fees that are customary and commensurate and that do not expose it to risk of loss.
- Investor A also holds a 20% pro rata direct equity interest in the VIE, which absorbs economics that would absorb more than an insignificant amount of the legal entity's expected variability and could potentially be significant to the VIE. Because of that other interest, the fees are variable interests (see Section 2.3.8).

CONCLUSION

Investor A has economics from its equity; the fees are excluded.

ANALYSIS

- The fees are customary and commensurate and do not expose Investor A to risk of loss, so they are excluded when evaluating whether Investor A has economics.
- However, Investor A has economics because it holds a 20% equity interest, which has the obligation to absorb the VIE's losses and the right to receive benefits from the VIE that **could** potentially be significant to the VIE.

4.4 IDENTIFYING THE PRIMARY BENEFICIARY IN RELATED PARTY GROUPS

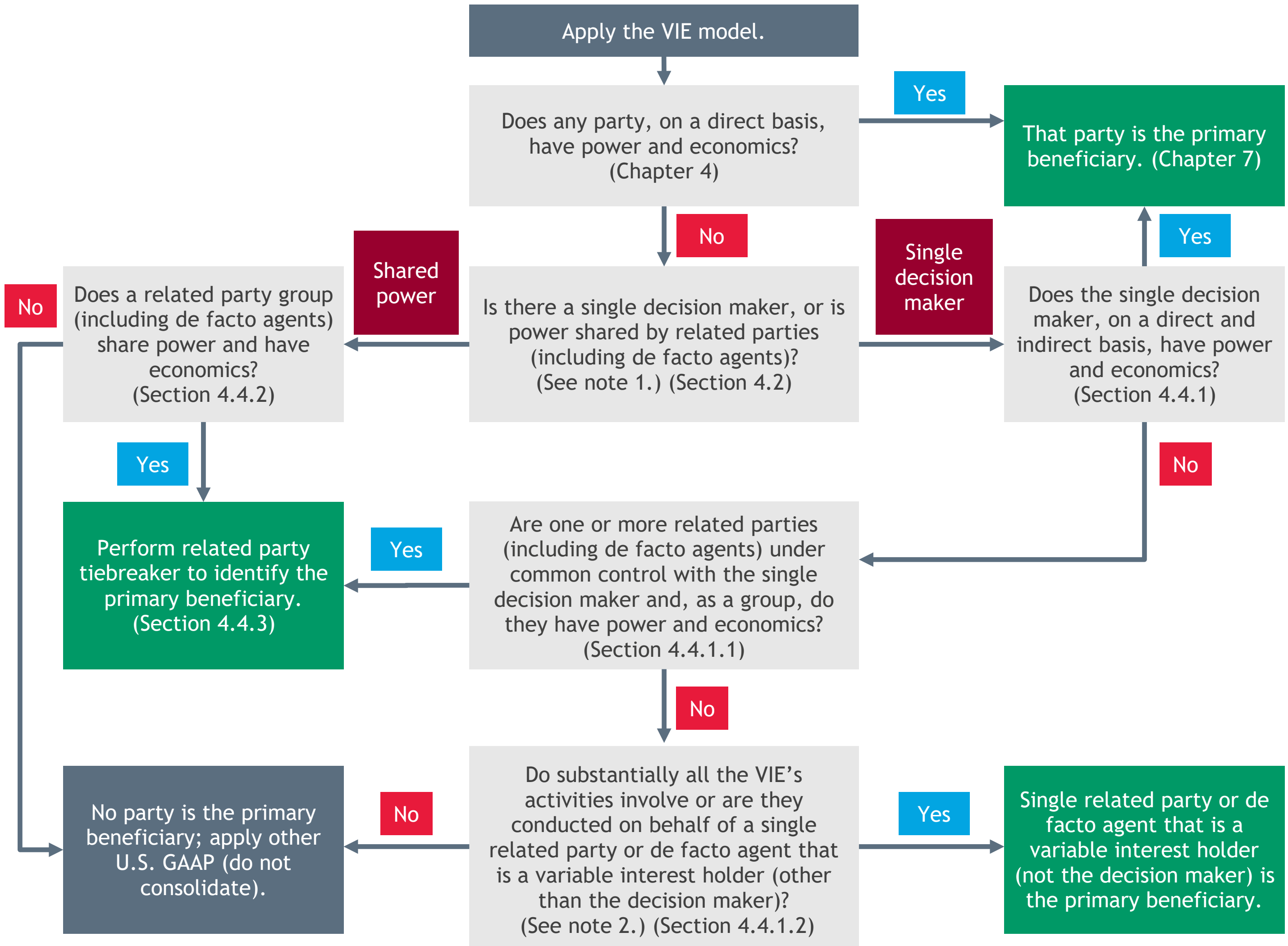
FASB REFERENCES

ASC 810-10-05-6 and ASC 810-10-25-42 through 25-44B

A reporting entity with a variable interest in a VIE must determine whether it is the primary beneficiary of that VIE. As shown in the flowchart:

- If a reporting entity **individually** has power (see Section 4.2) and economics (Section 4.3), it is the primary beneficiary. This analysis considers both direct and indirect interests through its subsidiaries (see Section 4.3.2).
- If a reporting entity does not individually have power and economics, it next considers the related party guidance unless another party (including a related party or de facto agent) individually has power and economics.
  - If another party individually has power and economics, that other party is the primary beneficiary, and the reporting entity's consolidation analysis stops. The reporting entity applies other U.S. GAAP to account for its interest (for example, the equity method) and discloses required information about its involvement with the VIE (see Section 8.3.1).
- If neither the reporting entity nor another party individually has power and economics, the reporting entity determines whether it is part of a related party group (including de facto agents) that collectively has the characteristics of a primary beneficiary (power and economics). For example:
  - The single decision maker does not individually have economics on a direct basis but has economics when considering indirect interests held through related parties (including de facto agents) that it does not control (see Section 4.4.1).
  - The single decision maker does not individually have economics on a direct and indirect basis but is part of a related party group under common control that has power and economics (see Section 4.4.1.1).
  - The single decision maker does not individually have economics on a direct and indirect basis, but substantially all the VIE's activities involve or are conducted on behalf of a single related party or de facto agent that is a variable interest holder (other than the decision maker) that has economics (see Section 4.4.1.2).
  - The reporting entity shares power (see Section 4.2.4) with one or more related parties or de facto agents, and the group collectively has economics (see Section 4.4.2).

This flowchart, adapted from ASC 810, illustrates how to identify the primary beneficiary.



- **Note 1:** See Section 4.2.3 for guidance when there appear to be multiple decision makers. One of these parties generally is identified as the single decision maker. See Section 4.2.4 for guidance when parties that are not related parties or de facto agents share power.
- **Note 2:** This step applies only if the reporting entity and its related party group (including de facto agents) have power and economics (but no party individually has power and economics) and are not under common control.

4.4.1 Single Decision Maker in a Related Party Group (Including De Facto Agents)

FASB REFERENCES

ASC 810-10-25-42 through 25-44B

As shown in the flowchart in Section 4.4, if no party individually has power and economics on a direct basis, the next step is to determine whether power is shared in a related party group (including de facto agents) that collectively has power and economics or whether there is a single decision maker.

- See Section 3.3.2.1 for guidance on identifying the activities that most significantly impact the VIE's economic performance.
- See Section 4.2.2 for guidance on determining whether a single decision maker exists and evaluating rights held by others.
- See Section 4.2.4 for guidance on determining whether shared power exists.
- See Chapter 5 for guidance on identifying related parties, de facto agents, and groups under common control.

A single decision maker is the primary beneficiary if it has economics, considering its direct and indirect interests, unless a single party (including its related parties and de facto agents) holds substantive kick-out rights or participating rights.

An indirect interest is one in which the party has economics indirectly through another legal entity. Indirect interests held through related parties and de facto agents generally are considered proportionately. For example, if the single decision maker owns a 20% interest in a related party that it does not control, and that related party owns a 40% interest in the VIE, the single decision maker's indirect interest in the VIE held through the related party is 8% (which is 20% of 40%). The single decision maker would add this 8% indirect interest to its direct interests in the VIE to determine whether it has economics.

Similarly, if an employee (or de facto agent) of the single decision maker owns an interest in the VIE and the single decision maker financed that employee's (or de facto agent's) interest, the single decision maker includes that financing as its indirect interest. For example, if a single decision maker's employees have a 30% interest in the VIE and the single decision maker financed one third of that interest, the single decision maker's indirect interest in the VIE through the financing is 10%.

If the single decision maker does not have power and economics when considering direct and indirect interests, the reporting entity applies the guidance and steps in Section 4.4.

BDO INSIGHTS — EVALUATING INDIRECT INTERESTS NOT HELD THROUGH A SUBSIDIARY

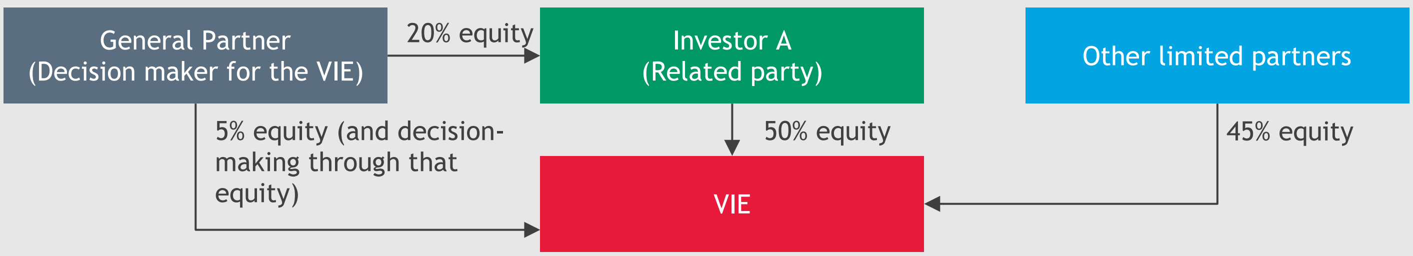
Indirect interests generally are considered proportionately. However, when variable interests do not absorb variability proportionately (for example, the interests expose a party only to losses, or do not proportionately share returns) reaching a conclusion requires the application of professional judgment based on the facts and circumstances. See Section 4.3.2 for guidance when an indirect interest is held through a subsidiary.

Example 4-16 illustrates a fact pattern in which the single decision maker has indirect interests through a related party it does not control.

EXAMPLE 4-16: SINGLE DECISION MAKER WITH INDIRECT INTEREST HELD THROUGH A RELATED PARTY IT DOES NOT CONTROL

FACTS

- A general partner formed a limited partnership and sold partnership interests to investors (limited partners), with ownership percentages as shown. All returns are shared pro rata.



- The general partner makes all decisions about the activities that most significantly impact the VIE's economic performance through its equity (and does not receive a decision-maker fee).
- The limited partners with equity at risk do not have substantive kick-out rights or participating rights, so the limited partnership is a VIE.
- The general partner also owns 20% of Investor A's equity. The general partner is a related party to Investor A but does not control Investor A (as determined in accordance with ASC 810).

CONCLUSION

The general partner has power and economics, so it is the primary beneficiary.

ANALYSIS

- Does any party, on a direct basis, have power and economics?
  - No. The general partner has power because it makes the decisions about the activities that most significantly impact the VIE's economic performance through its equity, and the limited partners with equity at risk do not have substantive kick-out rights or participating rights. (As determined using the four-step process in Section 4.2). However, the general partner's 5% direct interest in the VIE is not significant, so it does not individually have economics.
- Is there a single decision maker, or is power shared by related parties (including de facto agents)?
  - The general partner is the single decision maker.
- Does the single decision maker, on a direct and indirect basis, have power and economics?
  - Yes. The general partner has a direct interest of 5% and an indirect interest in the VIE of 10% (20% of 50%) through Investor A, its related party. Therefore, when considering its direct and indirect interests, the general partner has total economics of 15% (5% direct interest plus 10% indirect interest), which is significant. Accordingly, it individually has economics. Because it has power and economics, the general partner is the primary beneficiary.

Example 4-18 illustrates a scenario in which the single decision maker does not have power and economics when considering direct and indirect interests but is part of a related party group (including de facto agents) that collectively has the characteristics of a primary beneficiary (power and economics).

4.4.1.1 Single Decision Maker and Related Party Under Common Control

FASB REFERENCES

ASC 810-10-25-44A

The reporting entity performs the related party tiebreaker to determine which party in the related party group is most closely associated with the VIE when **both** of the following criteria are met:

- A single decision maker does **not** have power and economics when considering direct and indirect interests.
- The single decision maker is part of a related party group under common control, and that group collectively has power and economics. See Section 5.2.1 for more guidance on common control.

The party identified using the related party tiebreaker (see Section 4.4.3) is the primary beneficiary.

The SEC staff said a decision maker that does not have a variable interest cannot be identified as the primary beneficiary in the related party tiebreaker.

SEC STAFF GUIDANCE

Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments

Christopher D. Semesky, Professional Accounting Fellow, SEC Office of the Chief Accountant

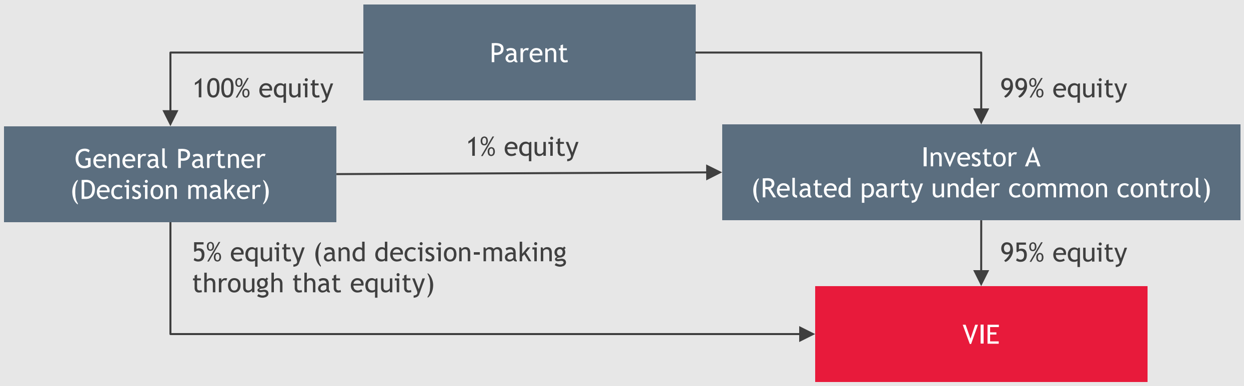
> *For purposes of illustration consider an entity that has four unrelated investors with equal ownership interests, and a manager that is under common control with one of the investors. The manager has no direct or indirect interests in the entity other than through its management fee, and has the power to direct the activities of the entity that most significantly impact its economic performance…*
>
> *In my example, if the manager determines that its fee is not a variable interest [the guidance in ASC 810 is] 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.* [Footnotes omitted.]

Example 4-17 illustrates a fact pattern with a single decision maker and a related party under common control in which this guidance applies.

EXAMPLE 4-17: SINGLE DECISION MAKER AND RELATED PARTY UNDER COMMON CONTROL

FACTS

- A general partner formed a limited partnership and sold partnership interests to Investor A (the limited partner), with ownership percentages as shown. All returns are shared pro rata.



- The general partner makes all decisions about the activities that most significantly impact the VIE's economic performance through its equity (and does not receive a decision-maker fee).
- The limited partner with equity at risk (Investor A) does not have substantive kick-out rights or participating rights, so the limited partnership is a VIE. (Regardless, such rights would not be considered because Investor A and the general partner are under common control; see Section 3.3.3.1).
- The general partner also owns 1% of Investor A's equity. Parent controls Investor A and the general partner (as determined in accordance with ASC 810).

CONCLUSION

To identify the primary beneficiary, the general partner and Investor A perform the related party tiebreaker to determine which party is most closely associated with the VIE (see Section 4.4.3).

ANALYSIS

- Does any party, on a direct basis, have power and economics?
  - No. The general partner has power because it makes the decisions about the activities that most significantly impact the VIE's economic performance through its equity and Investor A does not have substantive kick-out rights or participating rights. (As determined using the four-step process in Section 4.2). However, the general partner's 5% direct interest in the VIE is not significant, so it does not individually have economics.
- Is there a single decision maker, or is power shared by related parties?
  - The general partner is the single decision maker.
- Does the single decision maker, on a direct and indirect basis, have power and economics?
  - No. The general partner has a direct interest of 5% and an indirect interest in the VIE of approximately 1% (1% of 95%) through Investor A, its related party under common control. Therefore, when considering its direct and indirect interests, it has total economics of approximately 6% (5% direct interest plus 1% indirect interest), which is not significant. Accordingly, it does not individually have economics.
- Are one or more related parties (including de facto agents) under common control with the single decision maker and, as a group, do they have power and economics?
  - Yes. The general partner and Investor A collectively have power and economics. They are a related party group under common control, so they apply the related party tiebreaker to determine which party is most closely associated with the VIE and therefore is the primary beneficiary (see Section 4.4.3).

4.4.1.2 Substantially All Test When Identifying the Primary Beneficiary

FASB REFERENCES

ASC 810-10-25-44B and ASC 323-740-25-1

When identifying the primary beneficiary, the reporting entity generally is required to perform the substantially all test only if **both** of the following criteria are met:

- A single decision maker does **not** individually have power and economics when considering direct and indirect interests.
- The single decision maker is part of a related party group (including de facto agents) that collectively has the characteristics of a primary beneficiary (power and economics) and are **not** under common control.

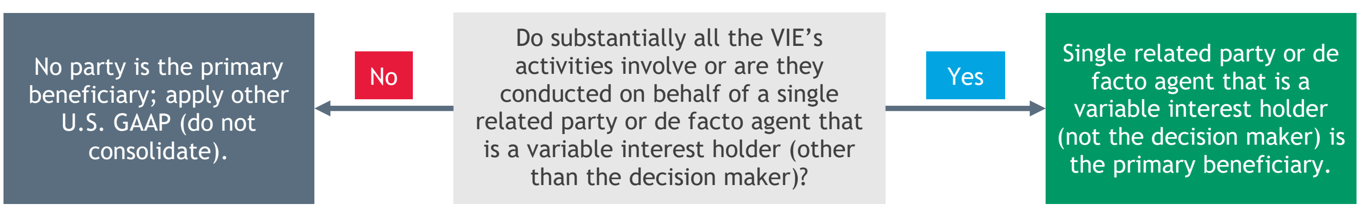
However, the substantially all test does not apply to investments in limited liability entities that for tax purposes are flow-through entities that meet the conditions in ASC 323-740-15-3 and ASC 323-740-25-1. In other words, the substantially all test does not apply to:

- (Before the adoption of ASU 2023-02) Investments in qualified affordable housing projects that meet specific conditions
- (After the adoption of ASU 2023-02) Investments in projects that generate income tax credits and other income tax benefits from a tax credit program and that meet specified conditions.

FASB PROJECT — ASU 2023-02

ASU 2023-02 expanded the population of legal entities that can be accounted for using the proportional amortization method and that can use the exception from the substantially all test. See BDO's Bulletin, [Accounting For Investments in Tax Credit Structures Using The Proportional Amortization Method](), for guidance.

The substantially all test is performed as follows (excerpted from the flowchart in ASC 810-10-05-6):



There is no quantitative threshold used to evaluate whether the substantially all test is met. Although economics are one factor to consider, the determination is primarily qualitative. Reaching a conclusion requires the application of professional judgment based on the facts and circumstances. If applicable, this evaluation should be consistent with assessments made when determining whether the business scope exception applies (see Section 1.4.4.2) and whether the legal entity is a VIE (see Section 3.6.2).

In practice, a reporting entity might consider the list of factors below (which is neither a checklist nor exhaustive) in determining whether substantially all the VIE's activities involve or are conducted on behalf of a single related party or de facto agent of the single decision maker (referred to below as simply "a single decision maker"). The importance of these factors varies depending on the VIE's purpose and design (see Section 2.2.2.2). No factor is determinative and not all factors must be present to conclude that the substantially all test is met.

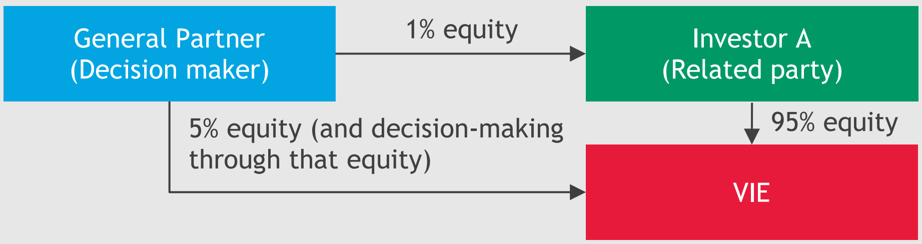
	The VIE buys or sells most of its products or services from or to a single related party (the greater the proportion, the stronger the indicator).
	A single related party has a call option to buy other variable interests in the VIE (a fixed-price, in-the-money, noncontingent option is a stronger indicator than a fair value, contingently exercisable option).
	Other investors have put options to sell some or all of their variable interests to a single related party.
	Most of the VIE's assets were acquired from a single related party (the greater the proportion, the stronger the indicator).
	Most of the VIE's assets are leased to or from a single related party (the greater the proportion, the stronger the indicator).
	Employees of a single related party manage the VIE's operations (for example, as board members, advisors, or like employees through loan-staffing or outsourcing).
	The VIE's employees receive compensation tied to the stock price or operating results of a single related party.
	The VIE's operations are substantially similar in nature, complementary to, or an extension of the activities of a single related party.
	The VIE's operations are more important to a single related party than to other variable interest holders.
	A single related party participates in making decisions about the activities that most significantly impact the VIE's economic performance.
	A single related party is obligated to fund the VIE's operating losses, or the VIE is financially dependent on that party.
	A single related party is explicitly or implicitly obligated to fund most of the capital of the VIE (the greater the obligation, the stronger the indicator). (See Section 2.6 on identifying implicit variable interests).
	The VIE outsources the activities that most significantly impact its economic performance to a single related party or vice versa.
	The VIE performs R&D activities critical to the economic performance of a single related party or vice versa.
	The economics are heavily skewed towards a single related party.

Example 4-18 illustrates a fact pattern in which the substantially all test applies.

EXAMPLE 4-18: SINGLE DECISION MAKER AND RELATED PARTY NOT UNDER COMMON CONTROL

FACTS

- A general partner formed a limited partnership on behalf of Investor A (the limited partner), with ownership percentages as shown. All returns are shared pro rata.



- The general partner makes all decisions about the activities that most significantly impact the VIE's economic performance through its equity (and does not receive a decision-maker fee) within the parameters and objectives specified by Investor A at inception in the limited partnership agreement.
- Investor A does not have substantive kick-out rights or participating rights, so the limited partnership is a VIE.
- The general partner also owns 1% of Investor A's equity. The general partner is a related party to Investor A but does not control Investor A (as determined in accordance with ASC 810).

CONCLUSION

Investor A is the primary beneficiary because no party individually has power and economics, but Investor A is part of a related party group that collectively has power and economics, and substantially all the VIE's activities involve or are conducted on behalf of Investor A.

ANALYSIS

- Does any party, on a direct basis, have power and economics?
  - No. The general partner has power because it makes the decisions about the activities that most significantly impact the VIE's economic performance through its equity, and the limited partners with equity at risk do not have substantive kick-out rights or participating rights. (As determined using the four-step process in Section 4.2). However, the general partner's 5% direct interest in the VIE is not significant, so it does not individually have economics.
- Is there a single decision maker, or is power shared by related parties?
  - The general partner is the single decision maker.
- Does the single decision maker, on a direct and indirect basis, have power and economics?
  - No. The general partner has a direct interest of 5% and an indirect interest in the VIE of approximately 1% (1% of 95%) through Investor A, its related party. Therefore, when considering its direct and indirect interests, the general partner has total economics of approximately 6% (5% direct interest plus 1% indirect interest), which is not significant. Accordingly, on a direct and indirect basis, it does not have economics.
- Are one or more related parties (including de facto agents) under common control with the single decision maker and, as a group, do they have power and economics?
  - No. The general partner and Investor A collectively have power and economics, but they are not under common control.
- Do substantially all the VIE's activities involve or they conducted on behalf of a single related party or de facto agent that is a variable interest holder (other than the decision maker)?
  - Yes. Substantially all the VIE's activities involve or are conducted on behalf of a single related party that is a variable interest holder (Investor A) because it specified the parameters and objectives used by the general partner for decisions and receives 95% of the VIE's economics; therefore, Investor A is the primary beneficiary.

Variation: If substantially all the VIE's activities did not involve or are not conducted on behalf of Investor A, no party would be the primary beneficiary.

4.4.2 Shared Power in a Related Party Group (Including De Facto Agents)

FASB REFERENCES

ASC 810-10-25-44

When a related party group (including de facto agents) shares power (see Section 4.2.4) and collectively has economics, the related party tiebreaker is performed to determine which party in the group (including de facto agents) is most closely associated with the VIE (see Section 4.4.3). That party is the primary beneficiary.

Example 4-19 illustrates the evaluation when power is shared in a related party group (including de facto agents).

EXAMPLE 4-19: TWO PARTIES THAT ARE RELATED PARTIES OR DE FACTO AGENTS SHARE POWER

FACTS

- Investor A and Investor B, which **are** related parties or de facto agents, formed a VIE to manufacture, distribute, and sell beverages.
- Investor A and Investor B each hold 50% of the VIE's equity.
- Investor A and Investor B must unanimously agree on decisions about manufacturing, distributing, and selling the beverages (which are the activities that most significantly impact the VIE's economic performance). If they cannot agree on decisions requiring unanimous consent, arbitration is required.

CONCLUSION

Investor A and Investor B share power over the VIE. To identify the primary beneficiary, they perform the related party tiebreaker (see Section 4.4.3).

ANALYSIS

- Does any party, on a direct basis, have power and economics?
  - No. Investor A and Investor B must unanimously agree on decisions about the activities that most significantly impact the VIE's economic performance, so they share power. (As determined using the four-step process in Section 4.2; see Example 4-8). Therefore, no party individually has power and economics.
- Is there a single decision maker, or is power shared by related parties?
  - Investor A and Investor B are related parties that share power.
- Does a related party group (including de facto agents) share power and have economics?
  - Yes. Investor A and Investor B are part of a related party group that shares power and has economics (through their equity), so they perform the related party tiebreaker to identify the primary beneficiary.

For variations on this fact pattern, see:

- Example 4-4: Two parties direct the same significant activities.
- Example 4-5: Two parties direct different significant activities.
- Example 4-8: Two parties that are not related parties or de facto agents share power.
- Example 4-9: Two parties must agree on some, but not all, significant activities.

4.4.3 Determining Which Party Is Most Closely Associated (the Related Party Tiebreaker)

FASB REFERENCES

ASC 810-10-25-44 through 25-44A

The related party tiebreaker is applied to determine which party is most closely associated with a VIE applies **only** in these two fact patterns:

- A single decision maker and its related party group are under common control. That group collectively has power and economics, but none of the related parties individually has power and economics (considering direct and indirect interests) (see Section 4.4.1.1).
- A related party group, including de facto agents (regardless of whether the group is under common control), shares power and collectively has economics (see Section 4.4.2).

Only in these two fact patterns is the party in the group that is most closely associated with the VIE its primary beneficiary.

DO NOT JUMP TO THE RELATED PARTY TIEBREAKER

A common misconception is that if the reporting entity does not individually have power and economics but is part of a related party group (including de facto agents) that collectively has power and economics, the related party tiebreaker applies. However, if another party in the related party group individually has power and economics, the related party tiebreaker does not apply.

Reaching a conclusion about which party in the related party group (including de facto agents) is most closely associated with the VIE requires the application of professional judgment based on the VIE's purpose and design (see Section 2.2.2.2) and the facts and circumstances, including **all** the factors listed below (none of which is determinative or carries more weight than the others).

FACTORS	CONSIDERATIONS
Principal-agency relationships	The existence of a principal-agency relationship between the parties. A principal-agency relationship exists if one member of the related-party group, including de facto agents (the agent) acts on behalf of another member (the principal). For example: ▶ If Investor A is an agent or de facto agent (see Section 5.3) of Investor B (the principal), Investor B may be most closely associated with the VIE. ▶ If third parties generally would identify one party as the group's representative or leader, that party may be most closely associated with the VIE.
Activities	The relationship and significance of the VIE's activities to the parties in the related party group (including de facto agents), considering the factors discussed in Section 3.6.2.

Economics and variability	A party's exposure to the variability associated with the VIE's anticipated economic performance. ▶ This evaluation is qualitative and quantitative. ▶ When decision-maker fees are variable interests, we believe a reporting entity should include the fees when evaluating this factor, even though the fees may be excluded when evaluating whether a decision maker individually has economics (see Section 4.3.3).
Purpose and design	The VIE's purpose and design (see Section 2.2.2.2). For example: ▶ Does the VIE's purpose and design benefit one member of the group more than others? ▶ Did a member of the group have greater influence on the VIE's design (or redesign)? ▶ Does a member of the group have a greater level of ongoing involvement with the VIE?

As discussed by the SEC staff, if another party in the related party group individually has power and economics, the related party tiebreaker does not apply.

SEC STAFF GUIDANCE

Remarks before the 2014 AICPA Conference on Current SEC and PCAOB Developments

Christopher F. Rogers, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *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. While common control arrangements do require careful consideration to determine if stated power is in fact substantive, 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.* [Footnotes omitted.]

4.5 ONGOING IDENTIFICATION OF THE PRIMARY BENEFICIARY

A reporting entity must continuously assess which party is the primary beneficiary. When a reporting entity is required to reconsider whether a legal entity is a VIE (see Section 3.6), it also reassesses whether the primary beneficiary has changed. But other changes in facts and circumstances can also change the primary beneficiary without triggering a reassessment of whether a legal entity is a VIE. The FASB did not list factors to consider for the ongoing identification of the primary beneficiary because it did not want to limit this analysis.[11]

BDO INSIGHTS — IDENTIFYING CHANGES IN THE PRIMARY BENEFICIARY

A reporting entity should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances that could affect its analysis. For example, changes in facts and circumstances, such as those listed below, might change the primary beneficiary.

[11] Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)*, paragraph A14.

- Amending governing documents (for example, articles of incorporation, bylaws, partnership agreements, membership agreements, operating agreements, or voting agreements)
- Changing decision-making rights for significant service providers
- Buying or developing new businesses or assets or changing the legal entity's business model
- Selling businesses or assets
- Moving from one phase of a VIE's business to the next
- Defaulting on loan covenants
- Restructuring, refinancing, or modifying debt
- Filing for or emerging from bankruptcy (see Section 6.5.2)
- Issuing equity or calling more capital
- Redeeming or repurchasing equity
- Modifying the terms of equity instruments
- Issuing guarantees, puts, or call options

The primary beneficiary also can change without any action by the VIE or other parties involved with the VIE. For example, the passage of time could cause options or other rights to expire, lapse, or become exercisable, which could change the primary beneficiary.

CONSIDER ALL CHANGES IN FACTS AND CIRCUMSTANCES WHEN IDENTIFYING THE PRIMARY BENEFICIARY

The FASB was clear that it did not want to limit the identification of the primary beneficiary to a list of specified events. Therefore, a reporting entity must consider all facts and circumstances to determine whether the primary beneficiary has changed. The examples listed above that could change the primary beneficiary are illustrative, not exhaustive. Determining whether there is a change in the primary beneficiary of a VIE requires the application of professional judgment based on the facts and circumstances.

When the primary beneficiary changes due to a change in the facts and circumstances, it consolidates or deconsolidates the VIE at that date (not at the beginning or end of a reporting period). See Chapter 7.

4.6 EXAMPLES OF IDENTIFYING THE PRIMARY BENEFICIARY

FASB REFERENCES

ASC 810-10-55-93 through 181 and ASC 810-10-55-199 through 205AI

ASC 810 includes examples that illustrate the identification of the activities that most significantly impact the VIE's economic performance and the primary beneficiary, which were adapted as listed in the table.

DESCRIPTION	EXAMPLE
Decision maker has a variable interest (commercial mortgage-backed securitization)	Example 4-20
Decision maker has a variable interest (asset-backed collateralized debt obligation)	Example 4-21
Decision maker has a variable interest (structured investment vehicle)	Example 4-22
Decision maker has a variable interest (commercial paper conduit)	Example 4-23
Decision maker has a variable interest (guaranteed mortgage-backed securities)	Example 4-24
Decision maker has a variable interest (residential mortgage-backed securitization)	Example 4-25
Decision maker has a variable interest (property lessor)	Example 4-26
Decision maker has a variable interest (manufacturer and retailer)	Example 4-27
Decision maker has a variable interest (investment fund)	Example 4-28
Decision maker has a variable interest (online distribution entity)	Example 4-29

EXAMPLE 4-20 (ADAPTED FROM ASC 810-10-55-96 THROUGH 55-109): DECISION MAKER HAS A VARIABLE INTEREST (COMMERCIAL MORTGAGE-BACKED SECURITIZATION)

FACTS

- A VIE was formed and financed with $94 million of investment-grade fixed-rate bonds (issued in three tranches to third-party investors) that mature in seven years and $6 million of equity held by the special servicer.
- The VIE used the proceeds to buy $100 million of BB-rated fixed-rate commercial mortgage loans maturing in seven years from the transferor. If the loans are extinguished before maturity, the borrowers must pay the full scheduled interest and principal.
- Interest and principal received are paid to the bondholders in order of seniority. Therefore, any shortfall is absorbed by the equity and the most subordinate bond class(es) in reverse order of priority.
- The transaction was marketed to potential bondholders as an investment in a portfolio of commercial mortgage loans with exposure to credit risk from potential loan defaults.

- The equity absorbs the first-dollar loss and receives any residual returns.
- The transferor is the primary servicer, which is an administrative role that includes remitting payments, administering escrow accounts, and collecting insurance claims.
- The special servicer makes decisions about delinquent or defaulted loans. The special servicer, as the equity holder, also has approval rights for budgets, leases, and property managers on foreclosed properties.
- The special servicer helped form the VIE and required the transferor to remove specific high-risk loans from the portfolio of loans bought by the VIE. It also reviewed the VIE's governing documents to determine whether the special servicer could quickly and effectively act when a loan is delinquent.
- The primary servicer (transferor) and special servicer (equity holder) receive fees that are customary and commensurate and do not explicitly expose them to risk of loss (see Section 2.3.8).
- No party has the right to remove the primary servicer or special servicer.

CONCLUSION

The special servicer has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to credit risk from potential defaults on principal and interest payments; the equity absorbs the first-dollar loss.
  - The VIE is not exposed to prepayment risk because the borrower is required to pay the full scheduled interest and principal if it prepays a loan before maturity.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along credit risk (from potential loan defaults) to interest holders (which earn a return from investing in the portfolio), while providing liquidity for the transferor to originate other loans.
- Step 3: Identify the significant activities.
  - The activities that most significantly impact the VIE's economic performance are:
    - Managing delinquent and defaulted loans.
    - Approving budgets, leases, and property managers on foreclosed properties.
  - Servicing loans before delinquency or default is an administrative activity and does not significantly impact the VIE's economic performance and so it is disregarded.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The special servicer is the decision maker for managing delinquent and defaulted loans and has approval rights for budgets, leases, and property managers on foreclosed properties, which are the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The special servicer's decision-making rights come through fees that are variable interests. Even though the fees are customary and commensurate, the decision maker has other interests (100% of the equity) that would absorb more than an insignificant amount of the VIE's expected variability, so the fees are variable interests (see Section 2.3.8 and Example 2-10).
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Therefore, the special servicer has power.
- Economics.

- The fees are customary and commensurate and do not expose the special servicer to risk of loss, so they are excluded when evaluating economics.
- However, because of its equity interest, the special servicer has the obligation to absorb the VIE's losses and the right to receive benefits from the VIE that could potentially be significant to the VIE, so it has economics.

- Does any party, on a direct basis, have power and economics?
  - Yes. The special servicer has power and economics, so it is the primary beneficiary.

EXAMPLE 4-21 (ADAPTED FROM ASC 810-10-55-110 THROUGH 55-121): DECISION MAKER HAS A VARIABLE INTEREST (ASSET-BACKED COLLATERALIZED DEBT OBLIGATION)

FACTS

- A VIE was formed and financed with $90 million of AAA-rated fixed-rate bonds, $6 million of BB-rated fixed-rate bonds, and $4 million of equity. All the bonds were issued to third-party investors. The manager and a third-party investor hold 35% and 65% of the equity, respectively.
- The VIE used the proceeds to buy a portfolio of asset-backed securities with varying maturities and interest rates.
- The transaction was marketed to potential bondholders as an investment in a portfolio of asset-backed securities with exposure to credit risk from potential defaults on asset-backed securities in the portfolio and to the portfolio's interest rate risk. The equity absorbs the first-dollar loss and changes in credit risk and interest rate risk.
- The manager has discretion to buy and sell the VIE's assets within the parameters in the governing documents.
- The manager receives fees that are customary and commensurate, and it is not exposed to risk of loss (see Section 2.3.8).
- A simple majority of the AAA-rated debt holders can remove the manager without cause; no one party can unilaterally remove the manager (the debt is widely dispersed). However, the manager keeps its 35% equity interest in the VIE even if it is removed (the manager's decision-making rights are not part of its equity).
- The third-party equity investor has only protective rights (see Section 4.2.2.2).

CONCLUSION

The manager has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to credit risk from potential defaults on asset-backed securities in the portfolio and to interest rate risk.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along credit risk from potential defaults on asset-backed securities in the portfolio, the interest rate risk (from the spread between the interest the VIE earns on its portfolio and the interest paid to the bondholders), and for the manager to earn management fees. The equity absorbs the first-dollar loss and changes in credit risk and interest rate risk.
- Step 3: Identify the significant activities.
  - Buying and selling the assets in the portfolio.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The manager is the decision maker for buying and selling the assets in the portfolio, which is the activity that most significantly impacts the VIE's economic performance.

- Step 4b: Does the single decision maker have power through a variable interest? Yes. The manager's decision-making rights come through fees that are variable interests. Even though the fees are customary and commensurate, the manager has other interests (35% of the equity) that would absorb more than an insignificant amount of the VIE's expected variability; therefore, the fees are variable interests (see Section 2.3.8).
- Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
- Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. The third-party equity investor has only protective rights (see Section 4.2.2.2). Therefore, the manager has power.

▶ Economics.

- The decision-maker fees are customary and commensurate and do not expose the manager to risk of loss, so they are excluded when evaluating economics. However, because of its 35% equity interest, the manager has the obligation to absorb the VIE's losses and the right to receive benefits from the VIE that could potentially be significant to the VIE, so it has economics.

▶ Does any party, on a direct basis, have power and economics?

- Yes. The manager has power and economics, so it is the primary beneficiary.

EXAMPLE 4-22 (ADAPTED FROM ASC 810-10-55-122 THROUGH 55-133): DECISION MAKER HAS A VARIABLE INTEREST (STRUCTURED INVESTMENT VEHICLE)

FACTS

▶ A sponsor formed a corporation (which is a VIE, see Example 3-19) that was financed with $94 million of AAA-rated fixed-rate, short-term debt and $6 million of equity. Third-party investors hold the short-term debt and equity. Upon maturity, the VIE will refinance the short-term debt at market rates.

▶ The VIE used the proceeds to buy 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 VIE's purpose is to maximize the spread between returns on its asset portfolio and its weighted-average cost of funding. The sponsor marketed the transaction to potential debt investors as an investment in a portfolio of high-quality debt with exposure to credit risk from potential defaults on debt in the portfolio. The equity absorbs the first-dollar loss; is exposed to liquidity risk (because the average tenor of the legal entity's assets is greater than its liabilities); and absorbs expected residual returns from favorable changes related to credit, liquidity, fair value, and interest rates.

▶ The sponsor manages:

- Investing activities — Debt investments must comply with the VIE's established investment guidelines, including eligible investments, country risk exposures, diversification, and ratings.
- Funding activities — The VIE's debt is managed (including refinancing short-term debt upon maturity) to minimize the cost of borrowing, as well as the interest rate and liquidity risks, and to meet capital requirements.
- Defeasance activities — If the VIE's debt ratings fall below a specified level, the sponsor oversees the investment portfolio's liquidation and discharges the VIE's obligations.

▶ The sponsor receives fees that are customary and commensurate and cannot be removed without cause. Although the fee arrangement does not explicitly expose the sponsor to risk of loss, the sponsor determined that it has an implicit variable interest in the VIE because it is implicitly obligated to absorb losses that could potentially be significant to the VIE to protect its own reputation if the VIE does not operate as designed (see Sections 2.3.8 and 2.6).

- The debt holders have no voting rights. The equity holders have rights to veto amendments to the VIE's governing documents.

CONCLUSION

The sponsor has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is primarily exposed to credit, interest rate, and liquidity risks.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along credit, interest rate, and liquidity risks to the interest holders. The VIE was designed to give investors the opportunity to invest in a portfolio of high-quality debt investments, maximize the spread it earns between the returns on its asset portfolio and its weighted-average cost of funding, and generate management fees for the sponsor. The debt holders absorb credit risk from potential defaults on debt in the portfolio. The equity absorbs the first-dollar loss and favorable changes related to credit risk, fair value, and interest rate risk. The equity is also exposed to liquidity risk.
- Step 3: Identify the significant activities.
  - Managing the VIE's investing, funding, and defeasance activities.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The sponsor is the decision maker for managing investment, funding, and defeasance activities, which are the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The sponsor's decision-making rights come through fees that are variable interests. Even though the fees are customary and commensurate, the sponsor's implicit variable interest is an other interest that would absorb more than an insignificant amount of the VIE's expected variability; therefore, the fees are variable interests (see Section 2.3.8).
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. The equity investors' right to veto an amendment to the governing documents is a protective right because it relates to a fundamental change in the VIE's activities and is designed only to protect the equity investors' interests (see Section 3.3.2.3 and Section 4.2.2.2). Therefore, the sponsor has power.
- Economics.
  - The fees are customary and commensurate and do not expose the sponsor to risk of loss, so they are excluded when evaluating economics.
  - However, because of its implicit variable interest, the sponsor has the obligation to absorb losses from the VIE that could potentially be significant to the VIE, so it has economics.
- Does any party, on a direct basis, have power and economics?
  - Yes. The sponsor has power and economics, so it is the primary beneficiary.

EXAMPLE 4-23 (ADAPTED FROM ASC 810-10-55-134 THROUGH 55-146): DECISION MAKER HAS A VARIABLE INTEREST (COMMERCIAL PAPER CONDUIT)

FACTS

- A sponsor formed a VIE that was financed with $98 million of AAA-rated fixed-rate, short-term debt and $2 million of subordinated notes. Third-party investors hold the short-term debt and subordinated notes. Upon maturity, the VIE will refinance the short-term debt with existing investors or issue short-term debt to new investors.
- The VIE used the proceeds to buy a portfolio of debt investments from multiple issuers with an average maturity of three years.
- The sponsor issued a letter of credit equal to 5% of the VIE's assets.
- The sponsor also provided a liquidity facility to fund any cash flow shortfalls on the short-term debt caused by mismatches between collections on the debt investments and payments due to the short-term debt holders or by the VIE's inability to refinance or reissue the short-term debt upon maturity. However, the liquidity facility does not fund any cash flow shortfalls cause by defaults.
- Therefore, credit risk from potential defaults on the VIE's assets is absorbed first by the subordinated note holders, then by the sponsor's letter of credit, and finally by the short-debt holders.
- The transaction was marketed to potential debt holders as an investment in a portfolio of highly rated medium-term assets with minimal exposure to credit risk from potential defaults on debt in the portfolio. The sponsor designed the subordinated notes to absorb the first-dollar loss related to credit. The sponsor marketed the transaction to potential short-term debt holders as having protection from liquidity risk because of the sponsor's liquidity facility.
- The sponsor was significantly involved with creating the VIE and manages:
  - Debt investing activities — Deciding which short-term debt investments to buy.
  - Funding activities — Managing the short-term debt (including refinancing) to minimize the cost of borrowing, interest rate risks and liquidity risks, and to meet capital requirements.
  - Administrative activities — Monitoring the assets, arranging for debt placement, reporting monthly, and complying with the VIE's credit and investment policies.
- The sponsor receives fees that are customary and commensurate and that do not expose it to risk of loss (see Section 2.3.8). The sponsor cannot be removed without cause.
- The debt holders and subordinated note holders have no voting rights.

CONCLUSION

The sponsor has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to credit risk from potential defaults on debt in the portfolio, interest rate risk on differences between debt in the portfolio and the short-term debt issued, and liquidity risk caused by mismatches between collections on debt in the portfolio and payments due to the short-term debt holders or by the VIE's inability to refinance or reissue the short-term debt upon maturity.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along credit risk, interest rate risk (from the spread between the interest the VIE earns on its portfolio and its weighted-average cost of funding), and liquidity risks to the interest holders; give investors the opportunity to invest in a portfolio of highly rated medium-term assets; give the debt issuers in the portfolio access to lower-cost funding; and generate fees for the sponsor. The subordinated debt absorbs the first-dollar loss related to credit risk and interest rate risk. The liquidity facility absorbs liquidity risk.

- Step 3: Identify the significant activities.
  - Managing the VIE's debt investment portfolio.
  - Managing the VIE's funding.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The sponsor is the decision maker for managing the debt investment portfolio and the VIE's funding, which are the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The sponsor's decision-making rights come through fees that are variable interests. Even though the fees are customary and commensurate, the sponsor's letter of credit and liquidity facility are other interests that would absorb more than an insignificant amount of the VIE's expected variability; therefore, the fees are variable interests (see Section 2.3.8).
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Therefore, the sponsor has power.
- Economics.
  - The fees are customary and commensurate and do not expose the sponsor to risk of loss, so they are excluded when evaluating economics.
  - However, because of its letter of credit and liquidity facility, the sponsor has the obligation to absorb the VIE's losses and the right to receive benefits from the VIE that could potentially be significant to the VIE, so it has economics.
- Does any party, on a direct basis, have power and economics?
  - Yes. The sponsor has power and economics, so it is the primary beneficiary.

EXAMPLE 4-24 (ADAPTED FROM ASC 810-10-55-147 THROUGH 55-159): DECISION MAKER HAS A VARIABLE INTEREST (GUARANTEED MORTGAGE-BACKED SECURITIES)

FACTS

- A VIE was formed and financed with $100 million of investment-grade rated, 30-year, fixed-rate debt.
- It used the proceeds to buy $100 million of 30-year fixed-rate residential mortgage loans from a transferor.
- A guarantor absorbs 100% of the credit losses on the VIE's assets. The mortgage loans are underwritten by the transferor within the parameters set up by the guarantor.
- All the VIE's activities are specified by the trust agreement and servicing guide, which were both set up by the guarantor. Accordingly, no decisions are required until defaults on the underlying assets occur or are reasonably foreseeable.
- The transaction was marketed to potential debt holders as an investment in a portfolio of residential mortgage loans exposed to the guarantor's credit risk and to prepayment risk on the mortgage loans.
- Each month, debt holders receive interest and principal payments in proportion to their ownership interests. If there is a shortfall in loan payments or if a loan is foreclosed on and the sale of the underlying property does not earn enough proceeds to repay the loan, the guarantor will make up the shortfall to pay debt holders.
- The guarantor also is the special servicer for the VIE. If a mortgage loan is 120 days delinquent and meets other criteria, the guarantor (special servicer) has the right to buy the loan from the VIE. The special servicer cannot be removed without cause.

- In accordance with the governing documents, the guarantor (special servicer) is also responsible for the primary servicing of the loans, but (as allowed by the governing documents) hires the transferor to perform the primary servicing activities under the guarantor's supervision. The special servicer monitors the primary servicer's performance and has the right to remove the primary servicer if removal is in the debt holders' best interest.
  - Primary servicing occurs in accordance with the servicing guide set up by the guarantor, including collecting and remitting principal and interest, administering escrow accounts, and managing defaults. The primary servicer receives fees that are customary and commensurate (see Section 2.3.8).
  - However, when a loan is delinquent or is reasonably expected to become delinquent, the primary servicer proposes a default mitigation strategy, which the guarantor can approve or reject in favor of another action that is in the debt holders' best interest.
- As compensation for providing the guarantee and the services, the special servicer receives fees that are customary and commensurate (see Section 2.3.8).

CONCLUSION

The guarantor (special servicer) has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to credit risk from residential mortgage loans, prepayment risk, and the risk of changes in the value of the underlying real estate.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along credit risk, prepayment risk, and the risk of changes in the value of the underlying real estate to interest holders; give debt holders the opportunity to invest in a portfolio of residential mortgage loans with a third-party guarantee for 100% of the principal and interest payments due on the mortgage loans; give the transferor liquidity for originating loans and a servicing fee; and generate fees for the guarantor. The guarantor absorbs credit risk on the residential mortgage loans and the risk of changes in the value of the underlying real estate.
- Step 3: Identify the significant activities.
  - The activities that most significantly impact the VIE's economic performance are:
    - Managing delinquent and defaulted loans.
    - Managing the sale of the underlying real estate (if a loan defaults and is not bought by the guarantor).
  - The primary servicer's other activities (collecting and remitting principal and interest and administering escrow accounts) do not significantly impact the VIE's economic performance and so are disregarded.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The special servicer is the decision maker for managing delinquent and defaulted loans and manages the sale of the underlying real estate (if applicable), which are the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The special servicer's decision-making rights come through fees that are variable interests. Even though the fees are customary and commensurate, the guarantee exposes the special servicer to risk of loss, so they are variable interests (see Section 2.3.8).
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Therefore, the guarantor (special servicer) has power.
- Economics.

- The fees received as compensation for providing the guarantee and acting as special servicer are customary and commensurate, but because the guarantor (special servicer) is exposed to risk of loss through the guarantee, the fees are included when evaluating economics (see Section 4.3.3).
- Therefore, because of its guarantee, the guarantor has the obligation to absorb the VIE's losses that could potentially be significant to the VIE, so it has economics.

- Does any party, on a direct basis, have power and economics?
  - Yes. The guarantor (special servicer) has power and economics, so it is the primary beneficiary.

EXAMPLE 4-25 (ADAPTED FROM ASC 810-10-55-160 THROUGH 55-171): DECISION MAKER HAS A VARIABLE INTEREST (RESIDENTIAL MORTGAGE-BACKED SECURITIZATION)

FACTS

- A VIE was formed and financed with $100 million of 30-year, fixed-rate debt securities (comprised of a $90 million senior tranche and a $10 million residual tranche). The senior tranche securities are investment-grade rated and widely dispersed among third-party investors. The transferor holds the residual tranche securities.
- The VIE used the proceeds to buy $100 million of 30-year fixed-rate residential mortgage loans from the transferor.
- The residual tranche held by the transferor absorbs any defaults on the underlying loans first.
- The transaction was marketed to potential senior debt holders as an investment in a portfolio of residential mortgage loans with exposure to credit risk and prepayment risk on the mortgage loans.
- Each month, debt holders receive interest and principal payments in proportion to their ownership interests.
- The transferor is the servicer, which includes collecting and remitting principal and interest, administering escrow accounts, and managing defaults, which includes (as decided by the servicer):
  - Modifying the loan terms when default is reasonably foreseeable.
  - Temporarily stopping collections of principal and interest.
  - Allowing the borrower to sell mortgaged property, even if the expected sales proceeds would not fully repay the loan.
- The servicer (transferor) receives fees that are customary and commensurate (see Section 2.3.8) and cannot be removed without cause. The fee arrangement does not expose the servicer to risk of loss.

CONCLUSION

The transferor (servicer) has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to credit risk from residential mortgage loans, prepayment risk, and the risk of changes in the value of the underlying real estate.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along credit risk, prepayment risk, and the risk of changes in the value of the underlying real estate to its interest holders; give debt holders the opportunity to invest in a portfolio of residential mortgage loans; and give the transferor liquidity for originating loans, a servicing fee, and potential residual returns. The residual tranche absorbs credit risk on the mortgage loans.
- Step 3: Identify the significant activities.
  - The activities that most significantly impact the VIE's economic performance are managing defaults on mortgage loans (and default mitigation).

- The servicer's other activities (collecting and remitting principal and interest and administering escrow accounts) do not significantly impact the VIE's economic performance and so are disregarded.

- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The transferor (servicer) is the single decision maker because it has the right to manage defaults on mortgage loans (and default mitigation), which are the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The servicer's decision-making rights come through fees that are variable interests. Even though the fees are customary and commensurate, the residual tranche is an other interest that causes the fees to be variable interests (see Section 2.3.8).
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Therefore, the servicer has power.
- Economics.
  - The decision-maker fees are customary and commensurate and do not expose the servicer to risk of loss, so they are excluded when evaluating economics.
  - However, because it holds the residual tranche, the transferor (servicer) has the obligation to absorb the VIE's losses and the right to receive benefits from the VIE that could potentially be significant to the VIE, so it has economics.
- Does any party, on a direct basis, have power and economics?
  - Yes. The transferor (servicer) has power and economics, so it is the primary beneficiary.

EXAMPLE 4-26 (ADAPTED FROM ASC 810-10-55-78 THROUGH 55-80 ASC 810-10-55-172 THROUGH 55-181): DECISION MAKER HAS A VARIABLE INTEREST (PROPERTY LESSOR)

FACTS

- A corporation was formed and financed with $95 million of fixed-rate debt that matures in five years and $5 million of equity. It used the proceeds to buy a property, which it leased to a lessee with an AA credit rating. The corporation (the lessor legal entity) is a VIE (see Example 3-20).
- The lease has a five-year term and cannot be unilaterally terminated by either party.
- The lessee guaranted the property's residual value at the end of five years and has a fixed-price purchase option on the property for the same amount (the option price). If the lessee does not exercise the fixed-price purchase option at the end of the lease term, it must resell the property on the lessor legal entity's behalf.
  - If the property sells for less than the option price, the lessee must pay the lessor legal entity the difference between the option price and the sales proceeds up to a specified percentage of the option price.
  - If the property sells for more than the option price, the lessee keeps the excess.
- A third party provided a small additional residual value guarantee to the lessor legal entity.
- The lessor legal entity cannot buy other assets or sell the property for five years. The lessor legal entity was designed so the lessee has the right to use the property through an operating lease and to keep substantially all the risks and rewards from changes in the property value.
- The lessee directs maintenance and operations of the leased property (which affect the property's fair value), as well as reselling the property if it does not exercise its purchase option, which are the activities that most significantly impact the lessor legal entity's economic performance. The equity investors have only protective rights.

- The debt was marketed to potential debt investors as a fixed-rate investment in an AA-rated asset collateralized by the property.
- The lease is classified as a direct financing lease by the lessor legal entity and as an operating lease by the lessee.

CONCLUSION

The lessee has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to changes in the property's fair value at the end of five years and credit risk from a potential default by the lessee.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to give the lessee use of the property for five years and pass along substantially all the rights and obligations of ownership, including tax benefits, to the lessee. (See Example 2-7 for more discussion about the lessor legal entity's purpose and design.)
- Step 3: Identify the significant activities.
  - Maintaining and operating the property, which affect the property's fair value.
  - Reselling the property (if the lessee does not exercise its purchase option).
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The lessee directs the maintenance, operations, and reselling the property, which are the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The lessee's decision-making rights come through its variable interest (the lease). The fixed-price call option and residual value guarantee cause the lease to be a variable interest in the legal entity as a whole because the property is 100% of the fair value of VIE's assets (see Section 2.3.6 and Section 2.4).
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No. No party can remove the lessee or unilaterally terminate the lease (which would effectively kick-out the lessee).
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. The equity investors have only protective rights. Therefore, the lessee has power.
- Economics.
  - The lessee has the obligation to absorb the VIE's losses through the residual value guarantee and the right to receive benefits from the VIE that could potentially be significant to the VIE through its purchase option, so it has economics.
- Does any party, on a direct basis, have power and economics?
  - Yes. The lessee has power and economics, so it is the primary beneficiary.

EXAMPLE 4-27 (ADAPTED FROM ASC 810-10-55-199 THROUGH 55-205): DECISION MAKER HAS A VARIABLE INTEREST (MANUFACTURER AND RETAILER)

FACTS

- A manufacturer and a strategic investor formed a corporation (the legal entity) to sell goods to customers in a new country. The legal entity is a VIE.

- The legal entity is financed with $100 of equity contributed by the manufacturer and $3 million of 10-year fixed-rate debt financed by the strategic investor.
- Interest payments are due in priority before funds are available to the equity holder (the manufacturer).
- The manufacturer guarantees the fixed-rate debt to the strategic investor.
- The debt agreement states that upon the VIE's bankruptcy, the strategic investor can take possession of the VIE's assets.
- The governing documents give the manufacturer (the sole equity holder) the right to make the decisions about the activities that significantly impact the VIE's economic performance, which are:
  - Determining the VIE's sales and marketing strategy.
  - Setting the VIE's annual budget.

CONCLUSION

The manufacturer has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (including sales volume risk, retail price risk, inventory price risk, and other operating cost risks).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along operations risk to its interest holders, enable the manufacturer to extend its business into a new country, and earn a return for the manufacturer and strategic equity investor on their investments.
- Step 3: Identify the significant activities:
  - Establishing the sales and marketing strategy.
  - Setting the annual budget.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The manufacturer makes the decisions about setting the VIE's sales and marketing strategy and annual budget, which are the activities that most significantly impact the VIE's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The manufacturer's decision-making rights come through its equity, which is a variable interest.
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. The strategic investor's right to take possession of the VIE's assets if the VIE files for bankruptcy is a protective right because it relates to a fundamental change in the VIE's activities and is designed only to protect the strategic investor's interests (see Section 3.3.2.3 and Section 4.2.2.2). Therefore, the manufacturer has power.
- Economics.
  - The manufacturer has the obligation to absorb the VIE's losses through the guarantee and the right to receive benefits from the VIE that could potentially be significant to the VIE through the equity, so it has economics.
- Does any party, on a direct basis, have power and economics?
  - Yes. The manufacturer has power and economics, so it is the primary beneficiary.

EXAMPLE 4-28 (ADAPTED FROM ASC 810-10-55-205L THROUGH 55-205V): DECISION MAKER HAS A VARIABLE INTEREST (INVESTMENT FUND)

FACTS

- A fund manager (the general partner) formed an investment fund that is a limited partnership and sold partnership interests to investors (limited partners). The limited partnership is a VIE (see Example 3-26).
- The general partner marketed the partnership interests to the limited partners as an opportunity to earn returns by investing in a fund in which the general partner decides how to invest the fund's assets within the parameters and objectives in the limited partnership agreement.
- The general partner receives fees that are customary and commensurate, and it is not exposed to risk of loss. However, the general partner's equity ownership interest in the fund **would** (and could) absorb more than an insignificant amount of the fund's expected variability, which causes the fees to be variable interests (see Example 2-8).
- No limited partners are related parties of the general partner.
- The limited partners can redeem their interests within limits set forth by the fund, but such redemptions would not explicitly or implicitly cause the fund's dissolution or liquidation.
- The limited partners also cannot:
  - Remove the general partner or liquidate the fund without cause.
  - Block or participate in the limited partnership's significant financial and operating decisions made in the ordinary course of business (or block or veto decisions about the activities that most significantly impact the fund's economic performance). For example, the limited partners cannot participate in:
    - Approving budgets
    - Hiring, firing, and compensating management
    - Choosing and managing the investments in the fund

CONCLUSION

The general partner has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The fund (the limited partnership, which is a VIE) is exposed to equity price risk on the investments in the fund.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The fund's purpose and design is to expose the limited partners to the equity price risk on the investments in the fund.
- Step 3: Identify the significant activities.
  - Choosing and managing the investments in the fund.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The general partner has the right to make decisions about choosing and managing the investments in the fund, which are the activities that most significantly impact the fund's economic performance.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The general partner's decision-making rights come through fees that are variable interests. Even though the fees are customary and commensurate, the general partner's interest is an other interest that causes the fees to be variable interests (see Section 2.3.8).

- Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
- Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. The limited partners with equity at risk do not have substantive participating rights; therefore, the general partner has power.

- Economics.
  - The fees are customary and commensurate and do not expose the general partner to risk of loss, so they are excluded when evaluating economics.
  - However, because of its equity interest, the general partner has the obligation to absorb the fund's losses and the right to receive benefits from the fund that could potentially be significant to the fund, so it has economics.
- Does any party, on a direct basis, have power and economics?
  - Yes. The general partner has power and economics, so it is the primary beneficiary.

EXAMPLE 4-29 (ADAPTED FROM ASC 810-10-55-205Z THROUGH 55-205AI): DECISION MAKER HAS A VARIABLE INTEREST (ONLINE DISTRIBUTION ENTITY)

FACTS

- Investor A formed a corporation (the legal entity) to which it exclusively licensed intellectual property to operate in a new country. The legal entity is a VIE (see Example 3-21).
- The equity investors have voting rights only on administrative matters (that is, they hold only protective rights). The country where the VIE is domiciled prohibits foreign investment through equity (Investor A cannot directly own the VIE's equity).
- The license agreement gives Investor A the right to make all strategic and technical decisions for the VIE. For these services, Investor A receives fees that are not customary and commensurate and that give it the right to receive benefits from the VIE that could potentially be significant to the VIE. The license agreement cannot be terminated without cause.

CONCLUSION

Investor A has power and economics, so it is the primary beneficiary.

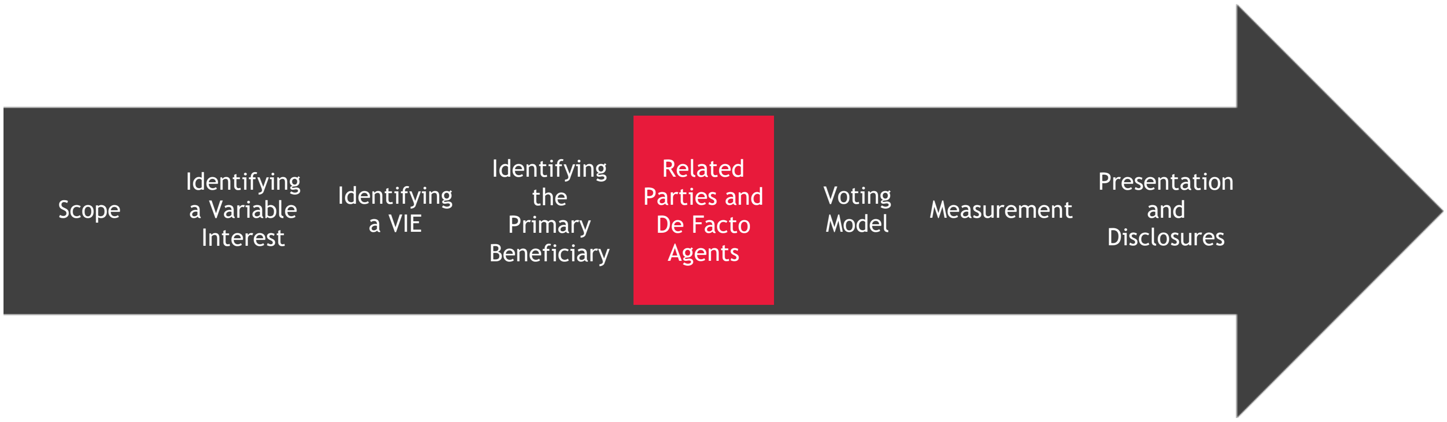
ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The VIE is exposed to operations risk (benefiting from using the intellectual property).
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The VIE's purpose and design is to create and pass along operations risk to its interest holders and enable Investor A to bypass foreign investment restrictions through a contractual arrangement to use the intellectual property to operate in a new country.
- Step 3: Identify the significant activities.
  - Making strategic and technical decisions for the VIE
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. Investor A is the single decision maker because it has the right to make all strategic and technical decisions for the VIE, which are the activities that most significantly impact the VIE's economic performance.

- Step 4b: Does the single decision maker have power through a variable interest? Yes. Investor A's decision-making rights come through the license agreement, which is a variable interest because the terms are not customary and commensurate (see Section 2.3.8).
- Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No.
- Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Therefore, Investor A has power.

- Economics.
  - The fees are not customary and commensurate (and therefore are included when evaluating whether Investor A has economics).
  - Therefore, because of its fees, Investor A has the right to receive benefits from the VIE that could potentially be significant to the VIE, so it has economics.
- Does any party, on a direct basis, have power and economics?
  - Yes. Investor A has power and economics, so it is the primary beneficiary.

Chapter 5 — Related Parties and De Facto Agents



5.1 OVERVIEW

In ASC 810, the term "related parties" includes parties as defined in ASC 850, *Related Party Disclosures*, and generally includes de facto agents.

Related parties in ASC 850 (Section 5.2) + De facto agents in ASC 810 (Section 5.3) = Related parties in ASC 810

The VIE model requires a reporting entity to identify a related party group (including de facto agents) because a related party or de facto agent may not be able to fully pursue its own interests (whether contractually or because of the nature of the relationship). A reporting entity may use related parties or de facto agents to try to structure a transaction to avoid consolidating a legal entity. Therefore, a reporting entity must consider those parties in specific parts of the VIE model. Not identifying all related parties (or de facto agents), or incorrectly identifying a party as a related party or de facto agent may result in incorrectly applying the VIE model. The following table shows where related parties and de facto agents are considered in the VIE model.

RELATED PARTY (AND DE FACTO AGENT) CONSIDERATIONS IN THE VIE MODEL	
Scope Exceptions	▶ Not-for-profit entities (see Section 1.4.1) ▶ Business scope exception (see Section 1.4.4)
Variable Interests	▶ Fees paid to a decision maker or service provider (see Section 2.3.8.2) ▶ Implicit variable interests (see Section 2.6)
Identifying a VIE	▶ Corporations and similar entities — Evaluating kick-out rights and participating rights (see Section 3.3.2) ▶ Limited partnerships and similar entities — Evaluating kick-out rights and participating rights (see Section 3.3.3) ▶ Assessing whether substantially all the legal entity's activities involve or are conducted on behalf of a related party group, including specific de facto agents (see Section 3.6.2)

RELATED PARTY (AND DE FACTO AGENT) CONSIDERATIONS IN THE VIE MODEL	
Identifying the Primary Beneficiary	▶ Identifying whether a single party (including its related parties and de facto agents) holds substantive kick-out rights or participating rights (see Section 4.2.2) ▶ Identifying the primary beneficiary in a related party group (including de facto agents) (see Section 4.4)
Initial measurement	▶ Initial measurement of a VIE if the primary beneficiary and VIE were under common control before the initial consolidation of the VIE (see Section 7.2.1)

5.2 RELATED PARTIES AS DEFINED IN ASC 850

FASB REFERENCES

ASC 850-10-20: Affiliate, Control, Principal Owners, Related Parties, and Immediate Family

In ASC 810, the term "related parties" includes related parties as defined in ASC 850.

Related parties in ASC 850 (Section 5.2) + De facto agents in ASC 810 (Section 5.3) = Related parties in ASC 810

ASC 850 defines the following terms.

TERM	DEFINITION AND INTERPRETIVE GUIDANCE
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.*

TERM	DEFINITION AND INTERPRETIVE GUIDANCE
Affiliate	*A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.* ▶ In this context, control is defined in ASC 850-10-20 as the "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise." ▶ For example, if Parent controls Subsidiaries A and B, they are affiliates and therefore related parties when evaluating whether Parent, Subsidiary A, or Subsidiary B has a controlling financial interest in a legal entity. ▶ See Section 5.2.1 for guidance on common control.
Principal owners	*Owners of record (or known beneficial owners) of more than 10 percent of the entity's voting interests of the entity.*
Immediate family	*Family members who might control or influence a principal owner or a member of management, or who might be controlled or influenced by a principal owner or a member of management, because of the family relationship.* See Section 5.2.1 Section 1.4.5.2 for guidance on immediate family.

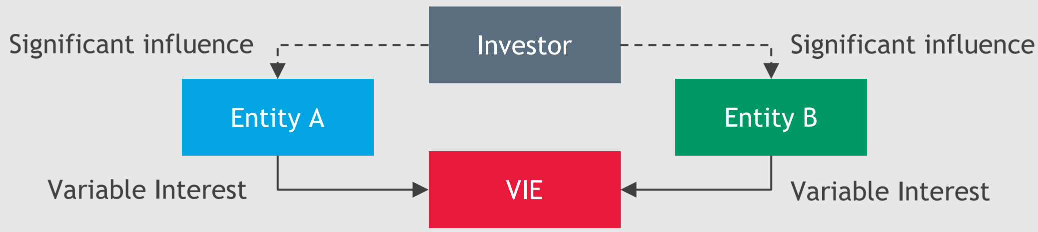
When applying the VIE model, it may be necessary to evaluate whether another investor controls or has significant influence over another entity involved with the legal entity to determine whether they are related parties.

Example 5-1 illustrates the identification of related party relationships in a complex structure.

EXAMPLE 5-1: RELATED PARTY RELATIONSHIPS

FACTS

- Investor has significant influence (but not control) over Entity A and Entity B.
- Entity A and Entity B each have a variable interest in the same VIE. However, they have no other transactions or arrangements with each other.



CONCLUSION

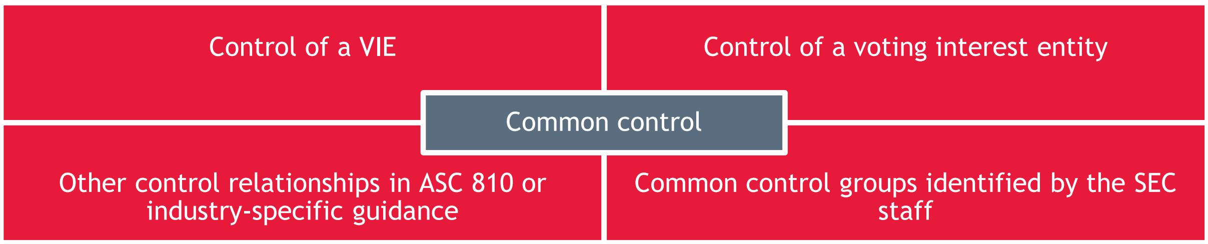
Entity A and Entity B are not related parties. The reporting entity must analyze whether they are de facto agents.

ANALYSIS

- Investor is a related party to Entity A and a related party to Entity B.
- However, because neither Entity A nor Entity B can control or significantly influence the other and are not controlled by Investor, they are not related parties.

5.2.1 Common Control When Identifying Related Parties

U.S. GAAP does not define the term "common control." Judgment must be applied to determine whether common control exists. ASC 810 includes two models for evaluating control: the VIE model and the voting model. It also describes other control relationships (such as control by contract, see Section 6.4.2), and U.S. GAAP includes industry-specific guidance for identifying control (for example, in ASC 958-810). Therefore, when evaluating whether common control exists, a reporting entity must consider all forms of control, as depicted in the following graphic. For example, if an ultimate parent, equity holder, or common control group controls one legal entity using the voting model and another legal entity using the VIE model, the legal entities are under common control.



In some cases, the legal entities may not be controlled by a single entity or individual; they may be controlled by a group of family members or legal entities affiliated in some other manner. The EITF discussed this issue in EITF Issue No. 02-5 but did not reach a consensus. The SEC staff's views are excerpted below.

SEC STAFF GUIDANCE

EITF Abstract Issue No. 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141*, paragraph 3

> *The FASB staff understands that the SEC staff has indicated that common control exists between (or among) separate entities only in the following situations:*
>
> *a. An individual or enterprise holds more than 50 percent of the voting ownership interest of each entity.*
>
> *b. Immediate family members hold more than 50 percent of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert).*
>
> *(1) Immediate family members include a married couple and their children, but not the married couple's grandchildren*
>
> *(2) Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration regarding the substance of the ownership and voting relationships.*
>
> *c. A group of shareholders holds more than 50 percent of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities' shares in concert exists.*

BDO INSIGHTS — IDENTIFYING COMMON CONTROL RELATIONSHIPS

A reporting entity generally should not extend the definition of common control beyond the immediate family member relationships described in EITF 02-5, paragraph 3(b). For example, a common control group excludes shares held by in-laws. Because of the lack of other authoritative guidance, both public and private companies apply the views of the SEC staff. Reaching a conclusion about whether common control exists requires the application of professional judgment based on the facts and circumstances.

In complex organizational structures, it may be necessary to determine the nature of the relationship between upper-tier entities directly or indirectly involved with a VIE, including whether they are under common control. For example, in asset management, private equity, and similar industries, it may be necessary to determine whether investors, general partners, managing members, or similar roles are under common control to determine whether a lower tier entity participates in a common control transaction.

It can be challenging to determine whether common control exists for legal entities with which management has no direct involvement, and this analysis may require professional judgment based on the facts and circumstances. A reporting entity cannot assume that they are under common control just because two legal entities have the same general partner, managing member, or are managed by the same (group of) advisors or funds.

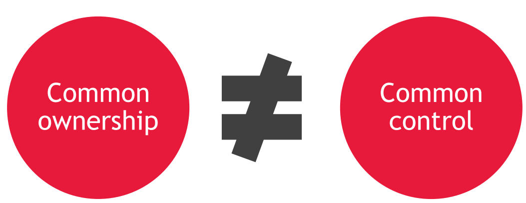
BDO INSIGHTS — COMMON CONTROL IS NARROWLY APPLIED

In issuing the accounting alternative for private companies under common control (see Section 1.4.5.2), the FASB stated that it:

> *…continues to believe that the term common control should be broader than what the SEC observed in Issue 02-5. For example, an entity owned by a grandparent and an entity owned by a grandchild could, on the basis of facts and circumstances, be considered entities under common control for the purposes of applying the private company accounting alternative.* [12]

However, we believe the FASB's statement applies only when evaluating whether a legal entity qualifies for the private company accounting alternative and not when identifying related parties under common control to apply other aspects of the VIE model. That is, we believe common control exists when legal entities have a common ultimate parent (identified using the VIE model, the voting model, or other guidance in ASC 810) or are controlled by a common control group as described by the SEC staff. A conclusion that common control exists in other fact patterns requires the application of professional judgment based on the facts and circumstances.

Common ownership, which is when two or more parties own the same legal entities in the same or different proportions, is not synonymous with common control unless the parties have an agreement to vote in concert or proxy their votes to one another. Therefore, legal entities with a high degree of common ownership (but are not under common control) cannot apply the common control guidance in ASC 810.



[12] ASU 2018-17, paragraph BC19.

AGREEMENTS TO VOTE IN CONCERT

When common ownership exists, a reporting entity should be alert for the possibility of a common control group. It should consider all evidence, including voting agreements and proxy rights, particularly when a key person (for example, a founder) is involved with the legal entities. However, the mere pattern of voting in concert without an agreement to do so does not mean a common control group exists.

5.3 DE FACTO AGENTS

FASB REFERENCES

ASC 810-10-25-43

In the VIE model, the term “related parties” generally includes de facto agents.

Related parties in ASC 850 (Section 5.2)	+	De facto agents in ASC 810 (Section 5.3)	=	Related parties in ASC 810

A de facto agent can be a person or a legal entity. Therefore, the following graphic uses the term “party” to describe de facto agents.

- A party that cannot finance its operations without subordinated financial support from the reporting entity (see Section 5.3.1)
- A party that received its variable interests in the legal entity as a contribution or a loan from the reporting entity (see Section 5.3.2)
- A party that is an officer, employee, or member of the governing board of the reporting entity (see Section 5.3.3)
- A party that cannot sell, transfer, and encumber (pledge) its variable interests without the approval of the reporting entity (see Section 5.3.4)
- A party that has a close business relationship to the reporting entity, such as the relationship between a professional service provider (for example, a lawyer or investment banker) and a significant client (see Section 5.3.5)

5.3.1 A Party That Cannot Finance Its Operations Without Subordinated Financial Support

FASB REFERENCES

ASC 810-10-20: Subordinated Financial Support and ASC 810-10-25-43(a)

A party that cannot finance its operations without subordinated financial support from the reporting entity is a de facto agent of the reporting entity because it may not be able to fully pursue its own interests apart from the reporting entity providing that support. The phrase "subordinated financial support" includes equity and most debt and refers to all variable interests that will absorb some or all of a VIE's expected losses (see Section 2.2).

5.3.2 A Party That Received Its Interests as a Contribution or Loan From the Reporting Entity

FASB REFERENCES

ASC 810-10-25-43(b)

A party that received its variable interests in the legal entity as a contribution or a loan from the reporting entity is a de facto agent of the reporting entity because it may not be able to fully pursue its own interests apart from the reporting entity.

BDO INSIGHTS — PUT RIGHTS AND SIMILAR INSTRUMENTS CAN CREATE DE FACTO AGENCY RELATIONSHIPS

A de facto agency relationship may also exist without an explicit contribution or loan if the substance of the arrangement is similar to a contribution or loan. For example, a put right or similar instrument that is deemed a financing of the investor's equity creates a de facto agency relationship between the equity holder and the counterparty (see Section 3.2.2.4). Reaching a conclusion about whether equity is financed or whether the substance of an arrangement creates a de facto agency relationship requires the application of professional judgment based on the facts and circumstances.

The SEC staff described a fact pattern in which it concluded that a buyout arrangement was not an in-substance loan.

SEC STAFF GUIDANCE

Remarks Before the 2020 AICPA Conference on Current SEC and PCAOB Developments

Damon Romano, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *Consider a fact pattern presented to OCA staff where the registrant invested in a VIE and began operating the VIE together with another party who had held an interest in the VIE since its formation. Due to its only customer choosing not to renew its contract, the VIE was winding down its activities, including performing under the remaining term of the existing contract. Following the final cessation of operations of the VIE, the registrant agreed to buy out the other party pursuant to a fixed-price buyout agreement…*
>
> *The registrant also considered if it was a related party with the other party, including if a de facto agency relationship existed [using ASC 810-10-25-44]. Specifically, the registrant*

> *considered whether the buyout agreement was akin to a loan from the registrant funding the other party's interests in the VIE [in accordance with ASC 810-10-25-43]. The registrant concluded that the buyout agreement was not economically equivalent to a loan based on the substance of the agreement because (1) the other party's equity interest was not directly financed by the registrant, (2) the other party had an equity interest in the VIE since it was founded and before the registrant had an equity interest, (3) the other party did not need a loan in order to continue participating in the business, and (4) the purpose of the buyout agreement was to facilitate dissolution of the VIE. In summary, the registrant concluded that no de facto agency relationship existed…*
>
> *…OCA staff also did not object to the registrant's view that the other party was not a related party, including that there was no de facto agency relationship in this set of facts and circumstances.* [Footnotes omitted.]

5.3.3 A Party That Is an Officer, Employee, or Board Member of the Reporting Entity

FASB REFERENCES

ASC 810-10-25-43(c)

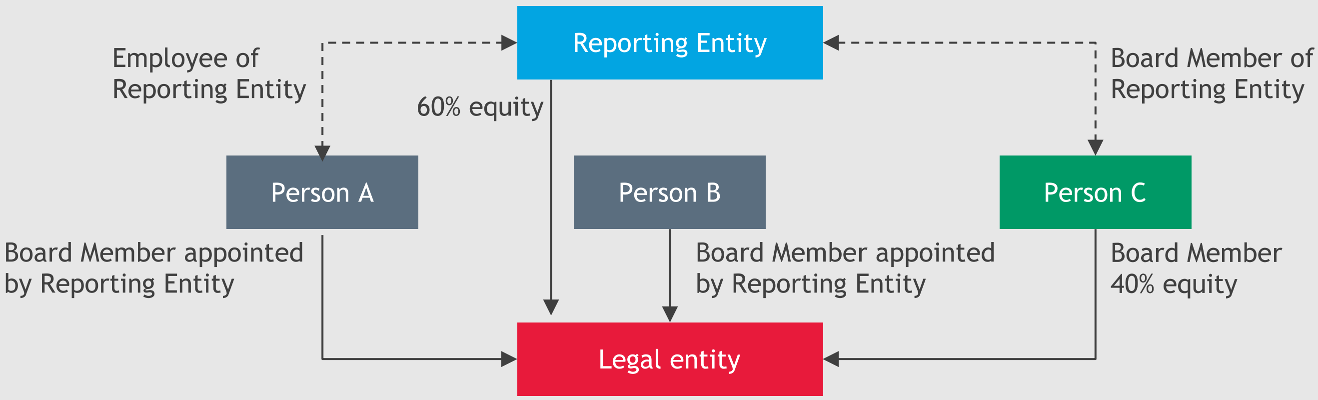
A party that is an officer, employee, or member of the governing board (for example, the board of directors) of the reporting entity is a de facto agent of that reporting entity.

Example 5-2 illustrates the difference between rights held by a related party or de facto agent and the reporting entity's own rights.

Example 5-2: Officers, Employees, and Board Members

FACTS

- The reporting entity bought 60% of the legal entity's equity and obtained the contractual the right to appoint two members to the legal entity's board. The reporting entity initially appointed Person A and Person B.
- Person A is an employee of the reporting entity.
- Person B is not an officer, employee, or board member of the reporting entity.
- Person C, who is a member of the reporting entity's board, bought the remaining 40% of the legal entity's equity and obtained the contractual right to appoint one person to fill the remaining board seat, which initially is Person C.
- The legal entity is a VIE. All decisions about the activities that most significantly impact the legal entity's economic performance are made by the board (which comprises only three members) and require unanimous consent.



CONCLUSION

Person A and Person C are de facto agents of the reporting entity, while Person B is not. However, the two board seats of the legal entity held by Person A and Person B are the reporting entity's own seats when applying the VIE model.

ANALYSIS

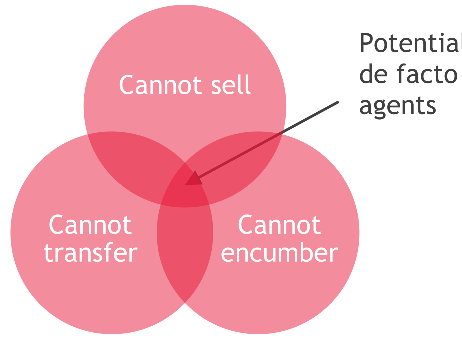
- Person A and Person C are de facto agents of the reporting entity because they are an employee and board member, respectively, of the reporting entity.
- The legal entity's board seats held by Person A and Person B are the reporting entity's own board seats because the reporting entity appoints the individuals to the legal entity's board through its equity (this conclusion applies regardless of their relationships to the reporting entity as employees, officers, or board members).
- The legal entity's board seat held by Person C is not the reporting entity's own board seat. However, Person C is a de facto agent of the reporting entity and holds that seat (vote).
- The decisions about the activities that most significantly impact the legal entity's economic performance require unanimous consent of the three board members. Therefore, the reporting entity cannot make decisions about those activities without Person C's approval and vice versa, which means the reporting entity and Person C share power (see Section 4.2.4).
- Because the reporting entity is part of a related party group (including de facto agents) that shares power and has economics, it performs the related party tiebreaker (see Sections 4.4.2 and 4.4.3) to identify the primary beneficiary.

5.3.4 A Party That Cannot Sell, Transfer, or Encumber Interests Without the Reporting Entity's Approval

FASB REFERENCES

ASC 810-10-25-43(d)

A party that cannot sell, transfer, **and** encumber (pledge) its variable interests without the reporting entity's approval is a de facto agent of the reporting entity. Such restrictions, or lockups, constrain the restricted party's ability to manage the economic risks or realize the economic rewards from its interests in the legal entity.



As shown in the graphic:

- A party that **cannot** take **any** of these actions (that is, a party restricted from all these actions) with respect to its variable interests **is** a de facto agent.
- A party that is **not** restricted from **all** these actions (that is, a party that can take one or more of these actions) is **not** a de facto agent.

BDO INSIGHTS — EVALUATING RESTRICTIONS WHEN IDENTIFYING DE FACTO AGENTS

Despite the graphic's simplicity, a reporting entity must consider all facts and circumstances when identifying de facto agency relationships.

For example, if an agreement precludes an investor from transferring and encumbering its variable interests in a legal entity without the reporting entity's approval but is silent about selling the variable interests, and a regulation outside the contract restricts the sale of those variable interests, a de facto agency relationship would exist, and the investor would be the reporting entity's de facto agent.

Sometimes, one party has the right to approve or restrict the other party from selling, transferring, or encumbering its variable interests in the legal entity, but the agreement states that such approval cannot be unreasonably withheld. Because of the subjectivity of this clause, we believe it is inappropriate to assume the party will not withhold its approval. In other words, such a clause may not prevent the party from exercising its right. Reaching a conclusion about whether that right is substantive requires the application of professional judgment based on the facts and circumstances and may require the assistance of legal counsel.

Once the reporting entity identifies restrictions, it evaluates whether the restrictions are asymmetrical or symmetrical.

Asymmetrical restrictions (one-way) →	The party is a de facto agent. However, de facto agents that result from one-way transfer restrictions are excluded when evaluating whether: ▶ The reporting entity and its related parties (including de facto agents) participated significantly in the legal entity's design, as part of evaluating the business scope exception (see Section 1.4.4.1). ▶ Substantially all the legal entity's activities involve or are conducted on behalf of the related party group (including de facto agents) for an investor with disproportionately fewer voting rights for determining whether the legal entity is a VIE (see Section 3.6.2).

Symmetrical restrictions (two-way)	The party is not a de facto agent as a result of transfer restrictions (it is not a de facto agent unless it has another characteristic of a de facto agent).

This table summarizes common terms in agreements and whether these terms create a de facto agency relationship when the restrictions are asymmetrical. However, terms and conditions might vary from those summarized below and should be evaluated based on the facts and circumstances before reaching a conclusion.

RIGHT	DESCRIPTION	CONCLUSION
Right of First Offer (ROFO)	▶ The seller offers to sell its variable interest first to the holder of the right. ▶ The holder of the right offers terms and conditions (including price). ▶ If the seller rejects the offer, it may sell the interest to another buyer, but only if the terms are more favorable to the seller than those offered by the holder of the right.	Not a de facto agent because the right does not restrict the seller from managing its economic interests in the legal entity.
Right of First Refusal (ROFR)	▶ The seller receives an offer from another party to buy the seller's variable interests, including the price and terms. ▶ The seller offers to sell the variable interest to the holder of the right before selling to the prospective buyer. ▶ The holder of the right can buy the variable interest at the same price and terms that were agreed with the prospective buyer. ▶ If the holder of the right rejects the offer, the seller may sell the variable interest under those terms.	Not a de facto agent because the right does not restrict the seller from managing its economic interests in the legal entity.
Right to restrict sale to a competitor	The party may not sell its interest to a competitor or less creditworthy party.	Not a de facto agent if other potential buyers exist because this right does not restrict the seller from managing its economic interests in the legal entity.
Right to hedge	The party cannot sell, transfer, or encumber its interest but may enter a derivative to hedge the risk related to its interest.	De facto agency relationship exists. Even though the party has managed its risk of ownership by hedging its investment, the hedge is not a restriction on the sale, transfer, or encumbrance of the interest.

5.3.5 A Party That Has a Close Business Relationship With the Reporting Entity

FASB REFERENCES

ASC 810-10-25-43(e)

A party with a close business relationship to the reporting entity, like the relationship between a professional service provider (for example, a lawyer or investment banker) and a significant client, is the reporting entity's de facto agent. This guidance was intended to identify when a reporting entity was "*avoiding consolidation of a variable interest entity by arranging to protect its interest or indirectly expand its holdings through other parties.*" [13]

The SEC staff discussed a fact pattern in which a relationship with a service provider created a de facto agency relationship.

SEC STAFF GUIDANCE

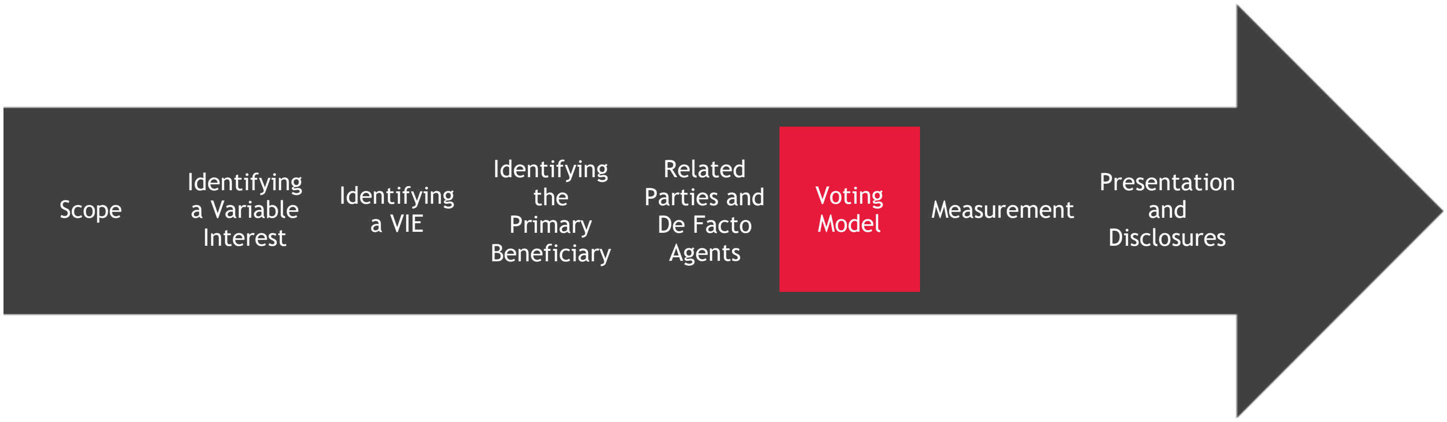
Remarks before the 2008 AICPA Conference on Current SEC and PCAOB Developments

Robert B. Malhotra, Professional Accounting Fellow, SEC Office of the Chief Accountant

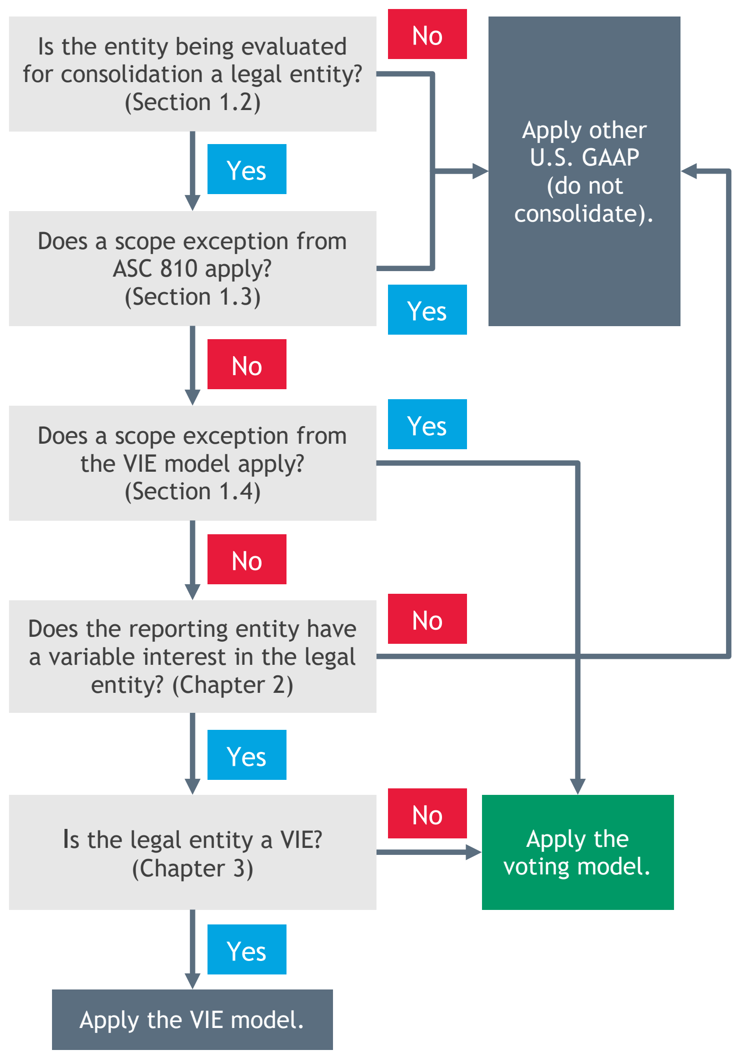
> *In this context, the staff believes that close business associates may only be considered related parties if one party can control or can significantly influence the other party to an extent that one of the parties might be prevented from fully pursuing their own separate interest should that party 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 850-10-20].* [Footnotes omitted.]

[13] FIN 46R, paragraph D41.

Chapter 6 — Voting Model



6.1 OVERVIEW



The consolidation guidance applies to all legal entities with some exceptions. A reporting entity first determines whether the reporting entity and legal entity are in the scope of the consolidation guidance in ASC 810. The reporting entity then determines whether the reporting entity and legal entity are in the scope of the VIE model; if so, it applies that model. If the legal entity is in the scope of the consolidation guidance but outside the scope of the VIE model, it is a voting interest entity. The reporting entity uses only the guidance in the general subsections of ASC 810 (for example, the voting model) to determine whether it controls the voting interest entity.

In the voting model, a reporting entity generally has a controlling financial interest if it directly or indirectly owns more than 50% of a corporation's outstanding voting shares (see Section 6.2) or more than 50% of a limited partnership's kick-out rights through voting interests (see Section 6.3).

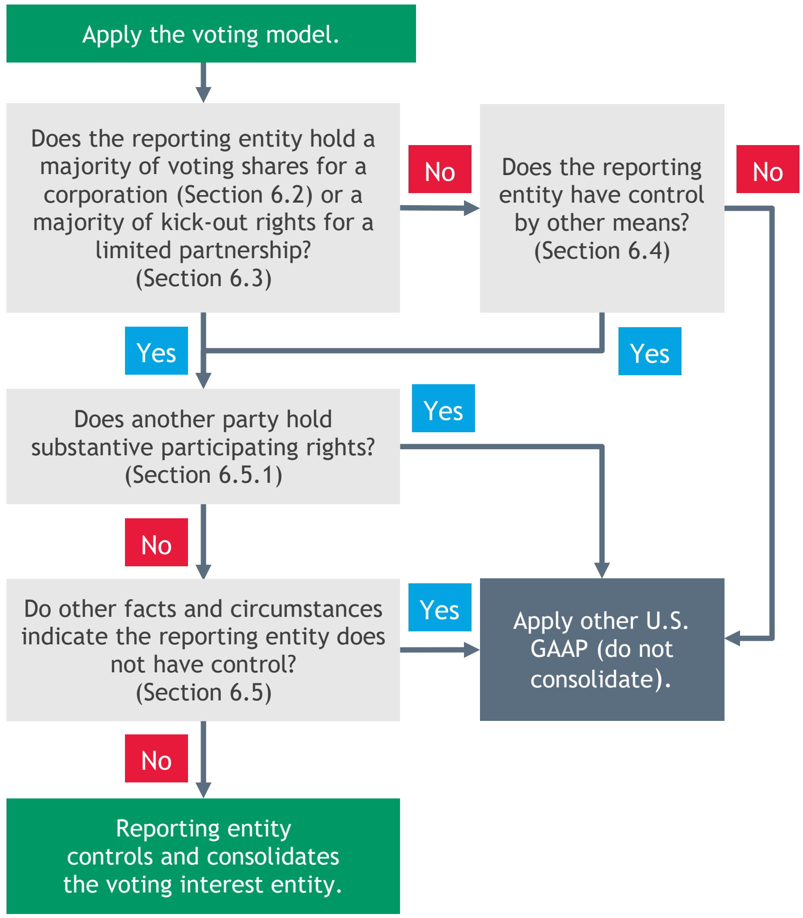
However, in the voting model, if other shareholders or limited partners have substantive participating rights, the majority shareholder (or the limited partner with more than 50% of the kick-out rights through voting interests) does not have a controlling financial interest (see Section 6.5.1) in the legal entity.

Control of a legal entity may also exist by other means; for example:

- Control of an NFP entity (see Section 6.4.1).
- Control by contract (see Section 6.4.2).
- Control over specific R&D arrangements (see Section 6.4.3).
- Control of a rabbi trust that is not a VIE (see Section 6.4.4).
- Control with less than a majority ownership (see Section 6.4.5).

Other facts and circumstances can also overcome the presumption that the majority shareholder (or the limited partner with a majority of kick-out rights through voting interests) controls the voting interest entity, including:

- The voting interest entity is in bankruptcy (see Section 6.5.2).
- The voting interest entity operates under foreign exchange restrictions, controls, or other government imposed uncertainties so severe that they cast significant doubt on the majority owner's ability to control the voting interest entity (see Section 6.5.3).
- Another party holds an option (or other instrument) to acquire a majority of the voting interests (or a majority of kick-out rights through voting interests) that is deep-in-the-money and currently exercisable (see Section 6.5.4).
- The reporting entity is a broker-dealer in the scope of ASC 940, and control is likely temporary (other reporting entities cannot apply this scope exception by analogy).



As discussed in ASC 810-10-05-3, all references to limited partnerships in ASC 810 include legal entities with governance structures similar to limited partnerships. For example, in some LLCs, the managing member functions like a general partner and the nonmanaging members function like limited partners. In other LLCs, the governance structure is more like a corporation.

Whether an LLC (or another legal entity) is determined to be similar to a limited partnership depends on whether a single equity holder (for example, the managing member) makes decisions about the significant financial and operating decisions in the ordinary course of business. See Section 3.3.1 for guidance on determining whether an LLC (or other entity) has a governance structure like a limited partnership or like a corporation.

In this Blueprint, references to corporations include legal entities similar in governance to a corporation, and references to limited partnerships include legal entities similar in governance to a limited partnership. Reaching a conclusion about whether an LLC or another legal entity is similar to a limited partnership, or a corporation requires the application of professional judgment based on the facts and circumstances.

6.2 CONTROL OF A CORPORATION IN THE VOTING MODEL

FASB REFERENCES

ASC 810-10-15-8 and ASC 810-10-25-1

In the voting model, a reporting entity generally has a controlling financial interest in a corporation if it owns more than 50% of the corporation's outstanding voting shares unless other shareholders hold substantive participating rights (see Section 6.5.1) or other facts and circumstances indicate control does not rest with the majority owner (see Section 6.5).

When the board of directors (not the shareholders) makes the significant financial and operating decisions for a corporation, the reporting entity must have the right to appoint and replace a majority of the board members (by contract or holding a majority of voting shares) to control a corporation using the voting model. Sometimes, a reporting entity holds less than a majority of the voting shares but contractually has the right to appoint a majority of the board members. For guidance on this fact pattern, see Section 6.4.5.

If the corporation's governing documents require more than a majority (that is, a supermajority) of shareholders to make the significant financial and operating decisions for the corporation, the reporting entity must have enough votes to meet the specified threshold to control the corporation.

When determining whether a reporting entity has a majority voting interest in a corporation, it considers indirect interests in the corporation held through another entity as follows:

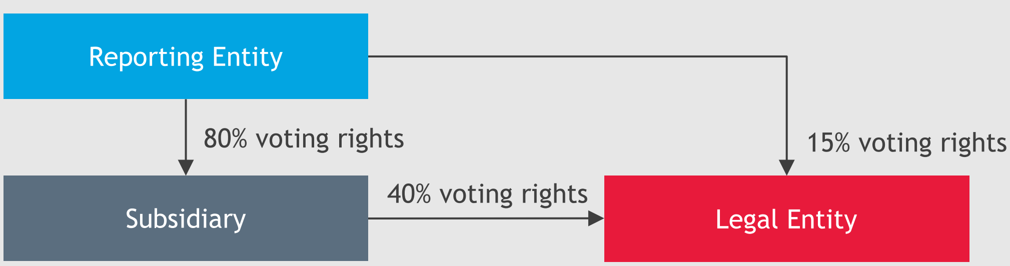
- It includes all voting shares (or contractual rights) held by its subsidiary (even if that subsidiary is not wholly owned).
- It excludes voting shares (or contractual rights) held by an entity the reporting entity does not control (for example, voting rights held by its equity method investee).

In neither case does the reporting entity include voting rights based on its proportionate interest in the corporation because it either controls or does not control the other party that holds the voting interests in the corporation. Examples 6-1 and 6-2 illustrate these concepts.

EXAMPLE 6-1: INDIRECT INTEREST THROUGH A CONTROLLED SUBSIDIARY

FACTS

- The reporting entity bought 15% of the legal entity's voting common stock. The legal entity is a voting interest entity (that is, not a VIE).
- A subsidiary of the reporting entity (which is 80% owned and controlled by the reporting entity) also bought 40% of the legal entity's voting common stock.
- No facts and circumstances indicate that control of the legal entity does not rest with the majority voting interests; no other investors hold substantive participating rights.



CONCLUSION

The reporting entity has a controlling financial interest in the legal entity using the voting model.

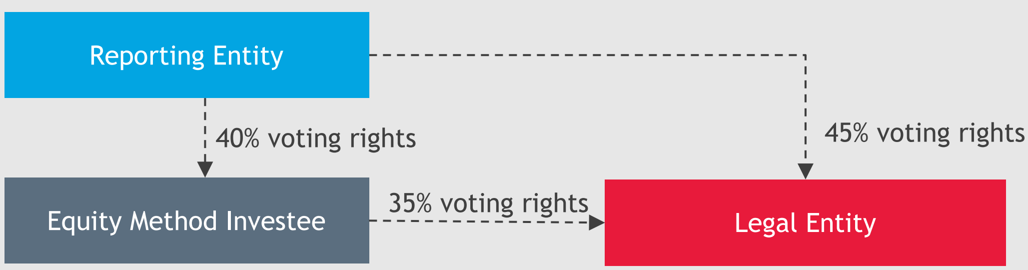
ANALYSIS

- Because the reporting entity has a controlling financial interest in its subsidiary, it includes all the voting rights held by its subsidiary (40%) when evaluating whether it has a controlling financial interest in the legal entity.
- Therefore, the reporting entity holds 55% of the legal entity's voting rights (40% indirectly held through its subsidiary + 15% directly held).
- Because the reporting entity holds a majority of the legal entity's voting rights, and no other facts and circumstances indicate that control does not rest with the majority owner, the reporting entity has a controlling financial interest in the legal entity using the voting model.
- The fact that the reporting entity's proportionate interest in the legal entity is only 47% (or 15% + [80% * 40%]) is irrelevant when identifying a controlling financial interest using the voting model.

EXAMPLE 6-2: INDIRECT INTEREST THROUGH AN EQUITY METHOD INVESTEE

FACTS

- The reporting entity bought 45% of the legal entity's voting common stock. The legal entity is a voting interest entity (that is, not a VIE).
- The reporting entity has a 40% equity method investment in an investee, which also bought 35% of the legal entity's voting common stock. The board of the equity method investee decides how to vote its shares in the legal entity. That is, the reporting entity does not control the equity method investee's votes with respect to the legal entity; it has only the ability to exercise significant influence over the equity method investee.
- No facts and circumstances indicate that control of the legal entity does not rest with the majority voting interests; no other investors hold substantive participating rights.



CONCLUSION

The reporting entity does not have a controlling financial interest in the legal entity using the voting model.

ANALYSIS

- Because the reporting entity does not have a controlling financial interest in the equity method investee, it excludes all the voting rights held by the equity method investee (35%) when evaluating whether it has a controlling financial interest in the legal entity.
- Therefore, the reporting entity holds only 45% of the legal entity's voting rights.
- Because the reporting entity controls less than a majority of the legal entity's voting rights, and no other facts and circumstances indicate that control does not rest with the majority owner, the reporting entity does **not** have a controlling financial interest in the legal entity using the voting model.
- The fact that the reporting entity's proportionate interest in the legal entity is 59% (45% + [40% * 35%]) is irrelevant when identifying a controlling financial interest using the voting model.

6.3 CONTROL OF A LIMITED PARTNERSHIP IN THE VOTING MODEL

FASB REFERENCES

ASC 810-10-15-8A, ASC 810-10-20: Kick-Out Rights (Voting Interest Entity Definition), and ASC 810-10-25-1A

Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by a corporation's shareholders. Therefore, in the voting model, a reporting entity has a controlling financial interest in a limited partnership if it holds more than 50% of the limited partnership's kick-out rights through voting interests unless other limited partners hold substantive participating rights or other facts and circumstances indicate that control does not rest with the holder of the majority of kick-out rights (see Section 6.5).

Kick-out rights are "*the rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.*"

For a limited partner to control a voting interest entity, the kick-out rights must meet the three conditions below.

Exerciseable by a single party (through a voting interest) + Exerciseable without cause (Section 3.3.3.1) + Substantive (Section 3.3.4.1) = Limited partner controls the voting interest entity

Sometimes, a limited partner may have withdrawal (redemption) rights. Concluding whether to treat withdrawal rights like kick-out rights and whether such rights are substantive requires the application of professional judgment based on the facts and circumstances (see Section 3.3.3.1 for guidance).

A reporting entity can hold a majority of kick-out rights in the limited partnership directly or indirectly through other controlled entities (subsidiaries). However, a reporting entity does not include interests held by other related parties (for example, equity method investees) or de facto agents when determining whether it has a controlling financial interest in a limited partnership using the voting model unless the reporting entity has the contractual ability to control such rights (see Section 6.2).

6.4 OTHER TYPES OF CONTROL IN THE VOTING MODEL

FASB REFERENCES

ASC 810-10-15-5, ASC 810-10-15-8 through 15-8A, ASC 810-10-15-10(c) through 15-10(e), and ASC 810-10-S99-2

Control of a legal entity also may exist by other means; for example:

- Control of an NFP entity (see Section 6.4.1)
- Control by contract (see Section 6.4.2)
- Control over specific R&D arrangements (see Section 6.4.3)
- Control of a rabbi trust (see Section 6.4.4)
- Control with less than a majority ownership (see Section 6.4.5)

SEC regulations codified in ASC 810 also provide limited guidance on the definition of control and the presentation of consolidated financial statements.

SEC RULES AND REGULATIONS

ASC 810-10-S99-2

Regulation S-X Rule 3A-02, Consolidated Financial Statements of the Registrant and its Subsidiaries [17 CFR 210.3A-02]

> *In deciding upon consolidation policy, the registrant must consider what financial presentation is most meaningful in the circumstances and should follow in the consolidated financial statements principles of inclusion or exclusion which will clearly exhibit the financial position and results of operations of the registrant. There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one entity directly or indirectly has a controlling financial interest in another entity. Other particular facts and circumstances may require combined financial statements, an equity method of accounting, or valuation allowances in order to achieve a fair presentation.*
>
> > *(a) Majority ownership: Among the factors that the registrant should consider in determining the most meaningful presentation is majority ownership. Generally, registrants shall consolidate entities that are majority owned and shall not consolidate entities that are not majority owned. The determination of majority ownership requires a careful analysis of the facts and circumstances of a particular relationship among entities. In rare situations, consolidation of a majority owned subsidiary may not result in a fair presentation, because the registrant, in substance, does not have a controlling financial interest (for example, when the subsidiary is in legal reorganization or in bankruptcy). In other situations, consolidation of an entity, notwithstanding the lack of technical majority ownership, is necessary to present fairly the financial position and results of operations of the registrant, because of the existence of a parent-subsidiary relationship by means other than record ownership of voting stock.*

Definitions of terms used in Regulation S-X (17 CFR 210.1-02)

> *Control. The term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise.*

BDO INSIGHTS — IDENTIFYING CONTROL RELATIONSHIPS

The SEC guidance provides context on the concept of control and on which financial presentation is most meaningful to users. However, we believe the guidance in ASC 810 (for example, the VIE and voting models) generally is sufficient to determine whether a reporting entity controls a legal entity because control through other means (such as through a lease or another contract) generally causes the legal entity to be a VIE. Therefore, we believe relying **solely** on the SEC guidance to identify whether the reporting entity controls the legal entity generally is not appropriate.

6.4.1 Control of a Not-for-Profit Entity by a For-Profit Entity

FASB REFERENCES

ASC 810-10-15-5, ASC 810-10-15-17(a), and ASC 958-810

As discussed in Section 1.4.1, a for-profit reporting entity generally applies the voting model and general subsections (not the VIE model) in ASC 810 to evaluate whether it controls an NFP entity.

For example, if a for-profit reporting entity creates a charitable foundation, it first evaluates whether the foundation meets the definition of an NFP entity in U.S. GAAP (see Section 1.4.1). If the foundation does, the for-profit reporting entity applies the general subsections (not the VIE model) to determine whether it controls the foundation.

BDO INSIGHTS — CONTROL OF AN NFP ENTITY WHEN THE FOR-PROFIT ENTITY HAS POWER BUT NOT ECONOMICS

ASC 810 does not explicitly state how to determine whether a for-profit reporting entity controls an NFP entity using the voting model when the for-profit reporting entity has power over the NFP entity through sole corporate membership, ownership of a majority voting interest, or other means but does not have an economic interest in the NFP entity.

In March 2021, the FASB discussed two approaches observed in practice for determining whether a for-profit reporting entity controls an NFP entity when it has power but no economics.

APPROACH 1

Power + Residual or economic interest = Control of a not-for-profit

Using Approach 1, a reporting entity must have both power and a contractual residual or economic interest in the NFP entity to control the NFP entity. In practice, a reporting entity often does not have a residual or economic interest if the legal entity meets the definition of an NFP entity in ASC 810. In defining an NFP entity, IRC Section 501(c)(3) states that "*none of the earnings may inure to a private shareholder or individual,*" which would include the reporting entity that sponsors the NFP entity. In practice, reporting entities that apply Approach 1 often conclude that they do **not** control the NFP entity. However, reaching a conclusion about whether the reporting entity has a residual or economic interest requires the application of professional judgment based on the facts and circumstances (for example, transactions between the NFP entity and the reporting entity).

APPROACH 2

Power = Control of a not-for-profit

Using Approach 2, a reporting entity needs only power to control the NFP entity. For example, this might include determining whether the reporting entity can make decisions or appoint and replace the NFP entity's board members. A reporting entity is more likely to control an NFP entity using Approach 2 than using Approach 1 because a residual or economic interest is not required. Reaching a conclusion about whether the reporting entity has power over an NFP entity requires the application of professional judgment based on the facts and circumstances.

Comparing the Approaches

While the FASB has indicated that either approach is acceptable, staff outreach suggested that most reporting entities apply Approach 1. When discussing the topic, some FASB members observed that a reporting entity that previously applied Approach 2 "*could consider a voluntary change in accounting policy that would result in deconsolidation.*"[14] However, to do so, a reporting entity must consider the requirements in ASC 250 for a voluntary change in accounting principle.

Regardless of which approach it applies, a reporting entity must comply with other U.S. GAAP with respect to its involvement with the NFP entity. For example, the reporting entity must comply with ASC 440, *Commitments*, and ASC 450, *Contingencies*.

6.4.2 Control by Contract

FASB REFERENCES

ASC 810-10-05-14 through 05-16, ASC 810-10-15-18 through 15-22, ASC 810-10-25-60 through 25-81, and ASC 810-10-55-206 through 55-209

The "Consolidation of Entities Controlled by Contract" subsections of ASC 810 apply to entities that are **not** VIEs or are outside the scope of the VIE model. Although written in the context of relationships between entities in the healthcare industry in medicine, dentistry, veterinary science, and chiropractic medicine (physician practices) in which the physician practice management entity does not own a majority of the physician practice's voting equity, this guidance could also apply to other similarly structured entities.

Arrangements in which a management entity does not own a majority of a physician practice's voting equity are common in the healthcare industry, which has laws and regulations that often preclude the management entity from owning equity in the physician practice. As an alternative, the management entity often:

- Buys the physician practice's net assets
- Assumes the physician practice's rights and responsibilities (other than the medical practice)
- Enters a long-term management agreement with the physicians to manage the physician practice
- Signs employment and noncompete agreements with the physicians

However, these arrangements may take various forms and allow varying degrees of participation in the physician practice by the management entity.

BDO INSIGHTS — CONTROL BY CONTRACT IS RARE OUTSIDE OF THE VIE MODEL

In our experience, legal entities generally are outside the scope of the "Consolidation of Entities Controlled by Contract" guidance because legal entities controlled by contract generally are VIEs. Accordingly, in practice, the guidance on legal entities controlled by contract rarely applies **unless** the legal entities are outside the scope of the VIE model. Reaching a conclusion that a reporting entity controls a legal entity using the "Consolidation of Entities Controlled by Contract" guidance requires the application of professional judgment based on the facts and circumstances.

[14] See FASB Minutes (March 24, 2021).

A management entity has a controlling financial interest in a physician practice using the "Consolidation of Entities Controlled by Contract" guidance if **all** the requirements below are met.

	REQUIREMENTS
Term	▶ The contract term (including renewal options unilaterally exercisable by the management entity) is for either the entire remaining legal life of the physician practice or at least 10 years. ▶ The contract cannot be canceled by the physician practice except for gross negligence, fraud, or other illegal acts by the management entity or the management entity's bankruptcy.
Control	The management entity has exclusive decision-making rights related to **both**: ▶ Total practice compensation of the licensed medical professionals, as well as the ability to establish and implement guidelines for their selection, hiring, and firing. ▶ The physician practice's ongoing, major, or central activities (except for the dispensing medical services), including **all** of the following: • Scope of services • Patient acceptance policies and procedures • Pricing of services • Negotiation and execution of contracts • Establishment and approval of operating and capital budgets • Debt issuance, if debt financing is an ongoing, major, or central source of financing for the physician practice
Financial interest	The management entity must have a significant financial interest in the physician practice that meets **both** of the following criteria: ▶ It is unilaterally saleable or transferable by the management entity ▶ It gives the management entity the right to receive income (as ongoing fees and as proceeds from the sale of its interest in the physician practice), which changes based on the physician practice's performance and the change in fair value thereof

ASC 810-10-25-60 through 81 and ASC 810-10-55-206 through 55-209 include guidance to help evaluate each of the above requirements.

DO NOT APPLY CONTROLLED BY CONTRACT GUIDANCE TO THE VIE MODEL

Some guidance in the "Consolidation of Entities Controlled by Contract" subsection differs significantly from the VIE model. A reporting entity cannot apply this guidance when evaluating legal entities using the VIE model.

6.4.3 Research and Development Arrangements in the Voting Model

FASB REFERENCES

ASC 810-10-15-10(c) and ASC 810-30

When a legal entity's activities relate to R&D (as defined in ASC 730-20-20), in rare cases, it may be appropriate for a reporting entity to apply ASC 810-30, *Consolidation — Research and Development Arrangements*. To be in the scope of ASC 810-30, **both** of the conditions in the following graphic must be met.

Either:

- The legal entity is outside the scope of the VIE model (see Section 1.4) or
- The legal entity is in the scope of the VIE model but is not a VIE (see Chapter 3)

\+

The sponsor provides all the funding for the R&D arrangement

=

In the scope of ASC 810-30

When the criteria above are not met, R&D arrangements may be in the scope of the VIE model or ASC 730-20, *Research and Development — Research and Development Arrangements*.

If the arrangement meets both criteria, the reporting entity applies ASC 810-30 to account for the arrangement. ASC 810-30 includes an example of the accounting for an R&D arrangement within its scope.

R&D ARRANGEMENTS CONDUCTED IN LEGAL ENTITIES OFTEN ARE VIES

In our experience, ASC 810-30 is rarely applied because the legal entities in R&D arrangements are often VIEs. However, reaching a conclusion about whether a legal entity is a VIE requires the application of professional judgment based on the facts and circumstances.

6.4.4 Rabbi Trusts That Are Not VIEs

FASB REFERENCES

ASC 810-10-15-10(e) and ASC 710-10-45-1

ASC 810 includes within its scope rabbi trusts and other deferred compensation vehicles. A rabbi trust is a grantor trust that a reporting entity might set up to fund compensation for a select group of management or highly paid executives. To qualify as a rabbi trust for tax purposes, the trust agreement must explicitly state that the trust's assets are available to satisfy general creditors' claims in case of the employer's bankruptcy. Rabbi trusts are in the scope of the VIE model and are often VIEs controlled and consolidated by their employer sponsors (see Section 1.3.1).

However, if a rabbi trust is not a VIE, ASC 810 refers to ASC 710, *Compensation*, which requires the employer sponsor to consolidate a rabbi trust and provides presentation guidance.

6.4.5 Control With Less Than Majority Ownership

FASB REFERENCES

ASC 810-10-15-8

A reporting entity generally has a controlling financial interest in a voting interest entity if it directly or indirectly owns more than 50% of a corporation's outstanding voting shares (see Section 6.2) or a limited partnership's kick-out rights through voting interests (see Section 6.3). However, ASC 810 acknowledges that control sometimes exists with less than a majority ownership of voting shares. For example, the governing documents, contracts, or an agreement between the investors might give a shareholder that holds less than a majority of the voting shares the right to appoint the majority of the board of directors (which makes the legal entity's significant decisions in the ordinary course of business).

BDO INSIGHTS — DE FACTO CONTROL DOES NOT EXIST IN U.S. GAAP

In IFRS, de facto control is the ability to make decisions with less than a majority of votes based on the relative size of the voting interests and an analysis of historical voting patterns. For example, a party might have de facto control if it holds 49% of the votes and the rest of the voters are widely dispersed and rarely vote. While de facto control can result in control and consolidation in accordance with IFRS, the concept does not exist in U.S. GAAP.

In U.S. GAAP, to control a voting interest entity, a reporting entity must have the substantive contractual right to make the voting interest entity's significant financial and operating decisions. Therefore, the dispersion of voting rights and historical voting patterns are irrelevant. As a result, in these situations, it is critical to identify all substantive contracts and arrangements between the parties.

More information on control and consolidation under IFRS is available here.

Example 6-3 illustrates that de facto control does not exist in U.S. GAAP.

EXAMPLE 6-3 (ADAPTED FROM IFRS 10, PARAGRAPH B43): REPORTING ENTITY HOLDS SIGNIFICANTLY MORE INTERESTS THAN OTHER INVESTORS

FACTS

- A reporting entity acquires 48% of the voting rights of a corporation that is a voting interest entity (not a VIE).
- The bylaws require a majority vote of the shareholders (or of the directors elected by a majority vote of the shareholders) to make the voting interest entity's significant financial and operating decisions.
- Thousands of shareholders hold the remaining voting rights; none individually holds more than 1%.
- No shareholders have any arrangements to consult any others or make collective decisions.

CONCLUSION

The reporting entity does **not** control the voting interest entity.

ANALYSIS

- The bylaws require a majority vote of the shareholders to make the voting interest entity's significant financial and operating decisions.
- The reporting entity holds a 48% voting interest in the corporation. Although it may significantly influence the voting interest entity's significant financial and operating decisions, the reporting entity does not have a majority of the voting interests.
- U.S. GAAP does not include the concept of de facto control; therefore, the reporting entity does **not** control the voting interest entity.

In contrast, Example 6-4 illustrates a fact pattern in which the reporting entity holds less than a majority of voting shares but controls the voting interest entity in accordance with the governing documents.

EXAMPLE 6-4: REPORTING ENTITY CONTRACTUALLY HOLDS A MAJORITY OF BOARD SEATS

FACTS

- Investor A acquires 48% of the voting rights of a corporation that is a voting interest entity (not a VIE). Investor B and Investor C each acquire 26% of the voting rights.
- The bylaws state that the voting interest entity's significant financial and operating decisions (including approving the operating budget and capital expenditures budget and hiring, firing, and compensating management) are made by a majority vote by the board of directors, which has five members.
- A voting agreement among Investor A, B and C states that Investor A appoints three board members and that Investor B and Investor C each appoint one board member. No investor has the right to remove or replace a member appointed by another investor or to increase the board's size.
- The board members appointed by Investor B and Investor C do not have substantive participating rights.
- The stated shareholder voting percentages (that is, 48%, 26%, and 26%) are used only to vote on matters that are not expected to occur in the ordinary course of business (for example, filing for bankruptcy).

CONCLUSION

Investor A controls the voting interest entity.

ANALYSIS

- The bylaws require a majority vote of the board of directors to make the significant financial and operating decisions for the voting interest entity.
- Investor A **contractually** holds the right to appoint a majority of the board members (three of five, or 60%), so it controls the voting interest entity.
- Although other decisions that are not expected to occur in the ordinary of course business (for example, filing for bankruptcy) are made using the stated shareholder voting percentages and Investor A does not have a majority of those voting rights, such rights are protective and do not prevent Investor A from controlling the voting interest entity because the decisions are not expected to occur in the ordinary course of business.

6.5 WHEN CONTROL DOES NOT EXIST IN THE VOTING MODEL

FASB REFERENCES

ASC 810-10-15-10

A reporting entity generally has a controlling financial interest in a voting interest entity if it directly or indirectly owns more than 50% of a corporation's outstanding voting shares (see Section 6.2) or a majority of a limited partnership's kick-out rights through voting interests (see Section 6.3).

However, if other shareholders (or limited partners) have substantive participating rights, the majority shareholder (or limited partner with a majority of kick-out rights held through voting interests) does **not** have a controlling financial interest in the voting interest entity (see Section 6.5.1). Other facts and circumstances may indicate the majority shareholder (or limited partner that holds a majority of kick-out rights through voting interests) does not control the voting interest entity, including:

- The voting interest entity is in bankruptcy (see Section 6.5.2).
- The voting interest entity operates under foreign exchange restrictions, controls, or other government imposed uncertainties so severe that they cast significant doubt on the majority owner's ability to control the voting interest entity (see Section 6.5.3).
- Another party holds an option to acquire a majority of the voting interests (or a majority of kick-out rights held through voting interests), and that instrument is deep-in-the-money and currently exercisable (see Section 6.5.4).
- The reporting entity is a broker-dealer in the scope of ASC 940, *Financial Services — Brokers and Dealers*, and control is likely temporary (other reporting entities cannot apply this scope exception by analogy).

6.5.1 Rights Held by Others

FASB REFERENCES

ASC 810-10-15-10(a)(1)(iv), ASC 810-10-20: Participating Rights (Voting Interest Entity Definition), ASC 810-10-25-2 through 25-14, and ASC 810-10-55-1

A reporting entity generally has a controlling financial interest in a voting interest entity if it directly or indirectly owns more than 50% of a corporation's outstanding voting shares (see Section 6.2) or a majority of a limited partnership's kick-out rights through voting interests (see Section 6.3).

However, if other shareholders (or limited partners) have substantive participating rights, the majority shareholder (or limited partner with a majority of kick-out rights through voting interests) does **not** have a controlling financial interest in the voting interest entity.

Reaching a conclusion about whether a shareholder's or limited partner's rights overcome the presumption of control by the shareholder with a majority voting interest or the limited partner with a majority of kick-out rights through voting interests requires the application of professional judgment based on the facts and circumstances. The evaluation considers whether the rights, individually or in the aggregate, allow the holder to participate in (approve or veto) the voting interest entity's significant financial and operating decisions made in the ordinary course of business.

BDO INSIGHTS — **RIGHTS HELD BY OTHERS CAN PREVENT A MAJORITY OWNER FROM HAVING CONTROL**

The voting model does not require the shareholder or limited partner to hold substantive participating rights over **all** the legal entity's significant financial and operating decisions to prevent the majority shareholder (or limited partner with a majority of kick-out rights through voting interests) from having control. ASC 810 states that substantive participating rights individually or in the aggregate allow the holder to participate in significant financial and operating decisions made in the ordinary course of business. We believe a single substantive participating right prevents the majority owner from controlling a voting interest entity. However, reaching a conclusion about whether a right is participating (or merely protective), and whether that right is substantive, requires the application of professional judgment based on the facts and circumstances.

A reporting entity can evaluate rights held by others using a two-step process.

STEP 1

Determine whether the right is participating or protective (see Section 3.3.3.2 for guidance, which applies regardless of whether the voting interest entity is a corporation or a limited partnership). Protective rights do not affect whether the majority owner controls the voting interest entity.

STEP 2

If the right is participating, determine whether it is substantive based on the facts and circumstances (see Section 3.3.4.2 for guidance, which applies regardless of whether the voting interest entity is a corporation or a limited partnership). If an investor (or another party) has one or more substantive participating rights, the majority owner does not control the voting interest entity.

Reaching a conclusion about whether rights are substantive participating rights (or merely protective) requires the application of professional judgment based on the facts and circumstances.

The holder of a substantive participating right does not need to hold this right through equity to prevent the majority owner from controlling the voting interest entity. For example, a lender may have a substantive participating right. However, if a nonequity owner (or an equity holder that does not have equity at risk) holds a substantive participating right, the legal entity may be a VIE (see Section 3.3).

A substantive participating right does **not** give the holder control of the voting interest entity; such a right merely prevents other parties from controlling the voting interest entity.

If facts or circumstances (for example, the terms or exercisability of the rights) significantly change, a reporting entity reassesses whether rights are participating or protective, and whether those rights are substantive.

BDO INSIGHTS — REASSESSING WHETHER A RIGHT IS A SUBSTANTIVE PARTICIPATING RIGHT

Unless the reporting entity or the legal entity is outside the scope of the VIE model (see Section 1.4), the reporting entity reassesses whether changes in facts and circumstances cause the legal entity to be a VIE (see Section 3.7).

If the legal entity continues to be a voting interest entity upon such events (it does not become a VIE), we believe the reporting entity should reassess whether rights held by others are protective or participating. Therefore, a reporting entity should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances that could affect its analysis.

Example 6-5 illustrates the reassessment of rights held by others.

EXAMPLE 6-5 (ADAPTED FROM ASC 810-10-55-1(h)): SUBSTANTIVE PARTICIPATING RIGHT EXPIRES

FACTS

- One shareholder has a majority voting interest in a corporation that is a voting interest entity.
- An unrelated shareholder has the right to veto the corporation's annual operating and capital budgets for the first five years of the relationship (the veto right terminates at the end of five years). Approving the annual operating and capital budgets is a significant financial and operating decision in the ordinary course of business. There are no provisions indicating another course of action if the veto right is exercised (such as a provision in which the budget reverts to the prior year's budget or that gives one of the parties a tiebreaker vote).
- The right has substance because there are no significant barriers to exercise.

CONCLUSION

During the first five years of the relationship, the majority owner does not control the corporation; at the end of five years, it does (assuming no other changes in facts and circumstances).

ANALYSIS

- Step 1: Determine whether the right is participating or protective.
  - ASC 810 indicates the right to participate in establishing operating and capital budgets in the ordinary course of business is a participating right (see Section 3.3.3.2). Here, no other facts and circumstances indicate the right is protective, so the reporting entity concludes that the right to veto the annual operating and capital budgets is a participating right.
- Step 2: If the right is participating, determine whether it is substantive based on the facts and circumstances.
  - Because there are no significant barriers to exercising the right (for example, the holder can veto the budget until an agreement is reached), the veto right is substantive.
  - During the first five years, the right to veto the corporation's annual operating and capital budgets is a substantive participating right that overcomes the presumption of control by the majority owner. Therefore, the majority owner accounts for its interest in the corporation in accordance with other U.S. GAAP (for example, the equity method).

After the participating right expires at the end of five years, there are no longer any substantive rights or other facts or circumstances that overcome the presumption of control by the majority owner. Accordingly, the majority owner controls and consolidates the corporation as of that date. See Chapter 7 for guidance on initial measurement.

6.5.2 Bankruptcy

FASB REFERENCES

ASC 810-10-15-10(a)(1)(i) and (ii), ASC 810-10-40-4, and ASC 855-10-20: Subsequent Events

A reporting entity generally has a controlling financial interest in a voting interest entity if it directly or indirectly owns more than 50% of a corporation's outstanding voting shares (see Section 6.2) or a majority of a limited partnership's kick-out rights through voting interests (see Section 6.3).

However, depending on the facts and circumstances, a majority owner may not control a corporation or limited partnership in bankruptcy. Reaching a conclusion about whether a majority owner controls a legal entity in bankruptcy requires the application of professional judgment based on the facts and circumstances. The following table summarizes common scenarios and conclusions related to Chapter 11 bankruptcy in the U.S.

ENTITY FILING BANKRUPTCY	CONTROL ASSESSMENT
Subsidiary only	▶ The bankruptcy court generally approves or vetos significant financial and operating decisions for the subsidiary. While management (and the majority shareholder) may recommend actions to the court, generally, any significant financial and operating decisions are subject to review and approval by a trustee, who is appointed by the bankruptcy court and acts on the creditors' behalf. Such approval and veto rights prevent the majority owner from controlling the voting interest entity. Therefore, the former parent (majority owner) no longer controls the subsidiary.

ENTITY FILING BANKRUPTCY	CONTROL ASSESSMENT
Parent only	▶ Although the parent (the majority owner) is controlled by the bankruptcy court, a bankrupt parent continues to control the significant financial and operating decisions of its subsidiary that has not filed for bankruptcy. Therefore, the parent continues to control the subsidiary.
Parent and subsidiary (filing in different jurisdictions)	▶ Separate bankruptcy courts generally make the significant financial and operating decisions for each legal entity. Therefore, the former parent (majority owner) no longer controls the subsidiary.
Parent and subsidiary (filing in the same jurisdiction)	▶ If the bankruptcy court views the entities as a single group (that is, the group's assets will be used to settle the claims of the group's creditors), the parent continues to control the subsidiary.

BANKRUPTCY RULES IN FOREIGN COUNTRIES MAY NOT BE SIMILAR TO CHAPTER 11 IN THE U.S.

When applying ASC 810 and determining whether a majority owner controls a legal entity that files for bankruptcy outside the U.S. (or other than in accordance with Chapter 11 in the U.S.), a reporting entity must evaluate the facts and circumstances to determine whether the majority owner controls the legal entity.

BDO INSIGHTS — A VOTING INTEREST ENTITY MIGHT BECOME A VIE UPON FILING FOR BANKRUPTCY

Although the guidance in the table above is presented for voting interest entities that file for bankruptcy in accordance with Chapter 11 in the U.S., we believe the same concepts also would generally apply to VIEs. Generally, a reporting entity is not a VIE's primary beneficiary once the VIE files for bankruptcy because the reporting entity no longer has power (see Sections 4.2 and 4.5).

Filing for bankruptcy generally also causes reconsideration of whether a legal entity is a VIE (see Section 3.7) because the holders of the equity at risk collectively lack power (see Section 3.3). Therefore, when a legal entity files for bankruptcy, the reporting entity must consider the presentation and disclosure requirements for VIEs (see Chapter 8), as well as the other disclosure requirements in U.S. GAAP.

A majority owner generally loses control of a subsidiary that files for bankruptcy in accordance with Chapter 11 in the U.S. (assuming the parent does not also file for bankruptcy). However, in rare circumstances it may be appropriate for the majority owner to continue to consolidate the legal entity, as discussed by the SEC staff.

SEC RULES AND REGULATIONS

[2003 AICPA National Conference on Current SEC Developments]

Randolph P. Green, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *Recently, we were asked to consider whether the deconsolidation of a majority-owned subsidiary in bankruptcy was appropriate. We were willing to undertake such a consideration because, in part, we believe that, even when a subsidiary is in bankruptcy, there are circumstances where the continued consolidation of a subsidiary is more meaningful. For example, consider an instance where the parent has a negative investment, expects the bankruptcy to be brief, and expects further to regain control of the subsidiary. One might be appropriately concerned about the deconsolidation, recognition of a gain, and reconsolidation of a subsidiary by a parent in a short period of time.*
>
> *In the fact pattern we considered, the parent was the majority common shareholder, a priority debt holder, and the subsidiary's single largest creditor. Due to its creditor position, the parent was able to negotiate a prepackaged bankruptcy with the subsidiary's other creditors. The parent, pursuant to the terms of the prepackaged bankruptcy, expected to maintain majority-voting control after the bankruptcy. The parent also expected the bankruptcy to be completed in less than one year.*
>
> *While we are inclined to continue to believe that bankruptcy is indicative of the fact that control does not rest with the majority owner, we did not object to the parent's determination that the continued consolidation of its subsidiary during bankruptcy was more meaningful and that any loss of control would be temporary given the facts and circumstances.*
>
> *Obviously, a determination 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. It is not a conclusion that a registrant should make without thoroughly consulting with its auditors and one the company should consider discussing with us. In any event, the conclusion and its basis should be adequately disclosed and the company should periodically reassess its facts and circumstances to confirm the appropriateness of such a determination.*

BDO INSIGHTS — FILING FOR BANKRUPTCY GENERALLY IS A NONADJUSTING SUBSEQUENT EVENT

When a subsidiary files for bankruptcy after the balance sheet date, the (former) parent does not recognize that event in its consolidated financial statements as of the balance sheet date. ASC 855, *Subsequent Events*, defines the following:

- Recognized subsequent events, which are "events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet"
- Nonrecognized subsequent events, which are "events that provide evidence about conditions that did not exist at the date of the balance sheet date but arose subsequent to that date"

Under ASC 810-10-40-4, a parent deconsolidates a subsidiary as of the date it ceases to have a controlling financial interest. Therefore, it is inappropriate for a parent to deconsolidate a legal entity before it has lost control. Instead, the parent discloses the loss of control after the balance sheet date as a nonrecognized subsequent event.

6.5.3 Foreign Exchange Restrictions, Controls, or Government Imposed Uncertainties

FASB REFERENCES

ASC 810-10-15-10(a)(1)(iii) and ASC 830-20-30-2

A reporting entity generally has a controlling financial interest in a voting interest entity if it directly or indirectly owns more than 50% of a corporation's outstanding voting shares (see Section 6.2) or a majority of a limited partnership's kick-out rights through voting interests (see Section 6.3).

A majority owner might not control a voting interest entity if it operates under foreign exchange restrictions, controls, or other government imposed uncertainties so severe that they cast significant doubt on the majority owner's ability to control the voting interest entity. ASC 830 states that if the lack of exchangeability is other than temporary, the reporting entity must carefully consider the propriety of consolidating that foreign subsidiary.

FOREIGN EXCHANGE RESTRICTIONS REQUIRE EVALUATION

Reaching a conclusion about whether an increase in foreign exchange restrictions, controls, or other government imposed uncertainties prevents a majority owner from controlling a voting interest entity requires the application of professional judgment based on the facts and circumstances. Although foreign exchange restrictions, controls, or other government imposed uncertainties might make the foreign legal entity less profitable, make it more difficult for the foreign legal entity to do business, or constrain the range of decision-making rights, we believe the reporting entity may still have the ability to make the significant financial and operating decisions for the foreign legal entity within those constraints.

When a reporting entity evaluates whether it controls a foreign legal entity, it does so within the context of the foreign legal entity's purpose and design, which may evolve as foreign exchange restrictions, controls, or other government imposed uncertainties become more severe. A reporting entity must disclose the significant judgments it makes in this evaluation (see Section 8.3.1).

Reaching a conclusion about whether a majority owner controls a legal entity operating under foreign exchange restrictions, controls, or other government imposed uncertainties requires the application of professional judgment based on the facts and circumstances. A reporting entity's judgments should be consistent. For example, if the reporting entity concludes that tightening foreign exchange restrictions, controls, or other government imposed uncertainties causes it to lose control of a foreign legal entity, loosening those restrictions may cause the reporting entity to regain control of the foreign legal entity, as discussed by the SEC staff.

SEC STAFF GUIDANCE

Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments

Christopher D. Semesky, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *In the past year, [the SEC Office of the Chief Accountant] has observed registrant disclosures indicating a loss of control of subsidiaries domiciled in Venezuela. Disclosures indicate that these conclusions have been premised on judgments about lack of exchangeability being other*

than temporary and, also in some instances, the severity of government imposed controls. The application of U.S. GAAP in this area requires reasonable judgment to determine when foreign exchange restrictions or government imposed controls or uncertainties are so severe that a majority owner no longer controls a subsidiary. In the same way, a restoration of exchangeability or loosening of government imposed controls may result in the restoration of control and consolidation. In other words, I would expect consistency in a particular registrant's judgments around whether it has lost control or regained control of a subsidiary. In addition, I would expect registrants in these situations to have internal controls over financial reporting that include continuous reassessment of foreign exchange restrictions and the severity of government imposed controls.

Further, to the extent a majority owner concludes that it no longer has a controlling financial interest in a subsidiary as a result of foreign exchange restrictions and/or government imposed controls, careful consideration should be given to whether that subsidiary would be considered a variable interest entity upon deconsolidation because power may no longer reside with the equity-at-risk holders. As a result, registrants should not only think about clear and appropriate disclosure of the judgments around, and the financial reporting impact of, deconsolidation but also of the ongoing disclosures for variable interest entities that are not consolidated.
[Footnotes omitted.]

6.5.4 Potential Voting Rights (Options and Other Instruments) in the Voting Model

FASB REFERENCES

ASC 810-10-15-8 and ASC 810-10-25-14A

After they are exercised or become effective, options or other instruments (for example, forward contracts and convertible instruments) to acquire the equity of a voting interest entity may give the holder a controlling financial interest in the voting interest entity. ASC 810 does not explicitly address how to evaluate these potential voting rights when determining whether a reporting entity controls a voting interest entity.

However, ASC 810 states that a reporting entity generally has a controlling financial interest in a voting interest entity if it owns more than 50% of a corporation's **outstanding** voting shares or a majority of a limited partnership's kick-out rights through voting interests. When a reporting entity holds options or other instruments to acquire voting rights or kick-out rights in the future, it does not yet hold the equity. Therefore, a reporting entity generally does **not** control a voting interest entity simply by holding options or other instruments with potential voting rights.

Instead, the reporting entity evaluates whether it controls the voting interest entity based on outstanding voting rights and kick-out rights at the date of assessment, and applies other U.S. GAAP (for example, ASC 815, ASC 321, *Investments — Equity Securities)* to account for the instrument with the potential voting rights.

BDO INSIGHTS — OPTIONS AND OTHER INSTRUMENTS WITH POTENTIAL VOTING RIGHTS

In limited cases, we believe options and other instruments with potential voting rights could give the holder control of the voting interest entity (for example, a call option that is currently exercisable and either deep in-the-money or exercisable for nominal consideration). However, such an instrument may also result in the legal entity being a VIE (See Section 4.2.5). Reaching a conclusion that options and other instruments with potential voting rights give the holder control of a legal entity requires the use of professional judgment based on the facts and circumstances.

POTENTIAL VOTING RIGHTS ARE ASSESSED DIFFERENTLY IN IFRS

In U.S. GAAP, potential voting rights generally are not considered when determining whether the reporting entity controls the voting interest entity. However, in IFRS, potential voting rights, either individually or in combination with other rights, can give a reporting entity effective control of a legal entity. Therefore, when a reporting entity holds potential voting rights, it might reach a different conclusion regarding control using IFRS than it would using U.S. GAAP. [15] More information on control and consolidation under IFRS is available **here**.

[15] IFRS 10, *Consolidated Financial Statements,* paragraphs B34-B50 and ASU 2015-02, pages 5-6.

Chapter 7 — Measurement

7.1 OVERVIEW

A reporting entity (the parent) consolidates a legal entity (the subsidiary) as of the date it obtains control of the legal entity (not at the beginning or end of a reporting period) and does not recast prior periods.

It is important to determine whether a legal entity is a VIE because that can affect its initial measurement. This table shows some common fact patterns and the applicable initial measurement guidance.

FACT PATTERN	GUIDANCE
The VIE and its primary beneficiary were under common control before the primary beneficiary's initial consolidation of the VIE.	Apply the common control guidance in ASC 810 (that is, carryover basis) and do not recognize a gain or loss (see Section 7.2.1).
The voting interest entity and its parent were under common control before the initial consolidation of the voting interest entity.	Apply the common control guidance in ASC 805-50 (that is, carryover basis).
The VIE or voting interest entity is a business.	Apply the acquisition method in ASC 805, including recognizing goodwill (see Section 7.2.2).
The VIE is not a business.	Apply the acquisition method in ASC 805 but recognize a gain or loss instead of goodwill (see Section 7.2.2).
The voting interest entity is not a business.	Apply the asset acquisition guidance in ASC 805-50.
The VIE is a CFE.	Decide whether to elect the fair value measurement alternative (see Section 7.2.3).
The VIE or voting interest entity is contributed to (or formed by) a joint venture at the joint venture's formation date (after adopting ASU 2023-05).	Apply the guidance in ASC 805-60 (see Section 7.2.4).

After initial measurement, the consolidation principles in ASC 810 apply to both VIEs and voting interest entities. The subsequent measurement of the subsidiary's assets, liabilities, and NCI generally are the same regardless of whether the subsidiary is a VIE or a voting interest entity, including retaining specialized or industry-specific accounting. However, ASC 810 includes specific guidance for eliminating intra-entity transactions between a VIE and its primary beneficiary (see Section 7.3.1).

7.2 INITIAL MEASUREMENT OF A VIE

FASB REFERENCES

ASC 810-10-30-1 through 30-4, ASC 810-10-55-40, and ASC 805-10-25-5

A reporting entity consolidates a VIE when it becomes the primary beneficiary (not at the beginning or end of a reporting period) and does not recast prior periods.

The reporting entity's initial measurement of the VIE depends on whether:

- The VIE and its primary beneficiary were under common control before the primary beneficiary's initial consolidation of the VIE (see Section 7.2.1)
- The VIE meets the definition of a business in ASC 805 (see Section 7.2.2)
- The VIE is a CFE (see Section 7.2.3)
- The VIE is contributed to (or formed by) a joint venture at the joint venture's formation date (after adopting ASU 2023-05, see Section 7.2.4)

VIE STATUS MATTERS

Determining whether a legal entity is a VIE can affect:

- Initial measurement if the legal entity is not a business: U.S. GAAP has different requirements for the initial consolidation of a VIE that is not a business than for other asset acquisitions (see Section 7.2.2).
- Identifying the acquirer in a business combination: If the legal acquiree is a VIE, its primary beneficiary is always the accounting acquirer. If the legal acquiree is not a VIE, additional analysis may be necessary to determine which of the combining entities is the accounting acquirer (see Example 7-1).
- Disclosures (see Section 8.3).

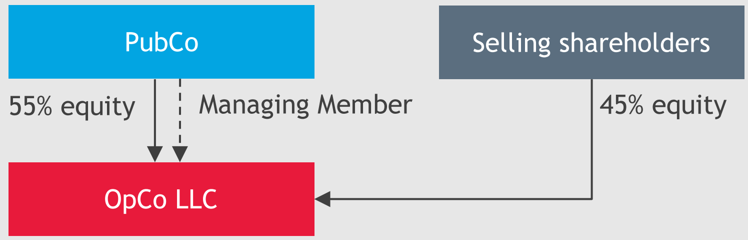
Example 7-1 illustrates how the determine of whether a legal entity is a VIE can affect the identification of the acquirer in a business combination.

EXAMPLE 7-1: VIE STATUS AFFECTS IDENTIFICATION OF ACCOUNTING ACQUIRER

FACTS

- PubCo legally acquired a 55% equity interest in OpCo LLC (which meets the definition of business in ASC 805) and its managing member interest.
- PubCo holds the managing member interest and, according to the governing documents, has the right to make the decisions about the activities that most significantly impact OpCo's economic performance through that interest. Therefore, OpCo has a governance structure like a limited partnership.
- The selling shareholders kept a 45% equity interest in OpCo and do not have substantive kick-out rights or participating rights.

- No single party or entity controls OpCo before and after the acquisition; therefore, the acquisition is not a common control transaction.



CONCLUSION

OpCo is a VIE; therefore, the primary beneficiary (PubCo) is automatically OpCo's accounting acquirer and applies the acquisition method of accounting.

ANALYSIS

- OpCo is a VIE because its governance structure is like that of a limited partnership and the members do not have substantive kick-out rights or participating rights (see Section 3.3.1 and Section 3.3.3).
- PubCo is the OpCo's primary beneficiary because it has both:
  - The power to direct the activities that most significantly impact OpCo's economic performance.
  - The obligation to absorb OpCo's losses and the right to receive benefits from OpCo that could potentially be significant to OpCo through its 55% equity interest
- ASC 805-10-25-5 states that a VIE's primary beneficiary is **always** the accounting acquirer. Because PubCo is OpCo's primary beneficiary, it is **automatically** the accounting acquirer regardless of other facts and circumstances (such as the composition of the board, the management team, or PubCo's shareholders). That is, the indicators provided in ASC 805-10-55-11 through 55-15 for identifying the accounting acquirer are **not** evaluated because that guidance is not applicable to VIEs, and the transaction cannot be accounted for as a reverse acquisition.

The consolidation (and initial measurement) of a VIE also applies to tiered structures. A VIE that is the primary beneficiary of a second VIE consolidates that second VIE. If another reporting entity consolidates the first VIE, that reporting entity consolidates the second VIE because the first VIE consolidates the second VIE.

7.2.1 Initial Measurement of a VIE in a Common Control Transaction

FASB REFERENCES

ASC 810-10-30-1

When a reporting entity becomes the primary beneficiary of a VIE, and the primary beneficiary and VIE were under common control (see Section 5.2.1) before the reporting entity's initial consolidation of the VIE, the reporting entity initially measures the assets, liabilities, and NCI of that VIE at the amounts reported in the ultimate parent's financial statements (or that would be reported if the ultimate parent issued U.S. GAAP financial statements). That is, the primary beneficiary initially measures a VIE under common control using the ultimate parent's carryover basis, consistent with other common control transactions.

7.2.2 Initial Measurement of a VIE Not in a Common Control Transaction

FASB REFERENCES

ASC 810-10-30-2 through 30-4 and ASC 805-30-30-1

When a reporting entity becomes the primary beneficiary of a VIE and the reporting entity and VIE were **not** under common control before its initial consolidation of the VIE, the reporting entity must evaluate whether the VIE meets the definition of a business in ASC 805 (including by using the "screen" test discussed in ASC 805-10-55-5A through 55-5C). The accounting is shown in the graphic.

The VIE is a business.	Apply the acquisition method in ASC 805, including recognizing goodwill.	Measure and recognize the assets, liabilities, and any NCI in accordance with the acquisition method in ASC 805 (generally at fair value with some exceptions).
The VIE is not a business.	Apply the acquisition method in ASC 805, but recognize a gain or loss instead of goodwill.	

As illustrated above, if the VIE does not meet the definition of a business, the primary beneficiary does not recognize goodwill. Instead, the primary beneficiary of a VIE that is not a business recognizes a gain or loss, which is calculated as shown in the graphic.

The sum of: 1. The fair value of consideration paid, including contingent consideration 2. The fair value of any NCI 3. The carrying amount of any previously held interests (for example, equity method investments)	−	The net amount of the VIE's identifiable assets and liabilities recognized and measured using ASC 805.	=	Gain or loss

An exception from the approach above is that the primary beneficiary initially measures assets and liabilities that it transferred to the VIE at, after, or shortly before the reporting entity became the primary beneficiary at the amounts the assets and liabilities would have been measured if they were not transferred. The reporting entity does not recognize a gain or loss for such transfers, which are similar to common control transactions.

MEASUREMENT OF PREVIOUSLY HELD INTERESTS

The measurement of previously held interests in the initial consolidation of a VIE that is not a business is different from the measurement of previously held interests in a business combination.

- ASC 810-10-30-4 specifies that the primary beneficiary of a VIE that is **not** a business must recognize its previously held interests at carryover basis.
- ASC 805-30-30-1 specifies that the primary beneficiary of a VIE that is a business must recognize its previously held interests at fair value.

7.2.3 Initial Measurement of a VIE That Is a Collateralized Financing Entity

FASB REFERENCES

ASC 810-10-15-17D, ASC 810-10-20: Collateralized Financing Entity and Beneficial Interests, ASC 810-10-30-10 through 30-16, ASC 810-10-35-6 through 35-9, and ASC 810-10-55-205AS through 55-205AT

When a reporting entity initially consolidates a VIE that is a CFE, it measures the CFE's financial assets and financial liabilities at fair value in accordance with ASC 820, *Fair Value Measurement*, or if it meets specific conditions discussed below, the reporting entity may elect to measure the CFE's financial assets and financial liabilities using a measurement alternative to ASC 820. The measurement alternative eliminates a mismatch that would otherwise occur by allowing the reporting entity to measure the CFE's financial assets and financial liabilities at the same amounts using the fair value of the financial assets or the fair value of the financial liabilities, whichever is more observable.

A CFE is a VIE that:

- Holds financial assets
- Issues beneficial interests that have contractual recourse only to those assets (such beneficial interests are classified as financial liabilities)
- Has nominal equity (if any)

A CFE may also hold:

- Nonfinancial assets temporarily because of default on the underlying debt instruments held as assets by the CFE or in an effort to restructure debt instruments held as assets by the CFE
- Other financial assets and financial liabilities that are incidental to the CFE's operations and that have carrying amounts approximating fair value (for example, cash, broker receivables, broker payables)

A beneficial interest is the right to receive from a trust or other legal entity all or a portion of specified cash inflows, including:

- Senior and subordinated shares of interest, principal, or other cash inflows passed through or paid through
- Premiums due to guarantors
- Commercial paper obligations
- Residual interests, whether debt or equity

A reporting entity can elect the measurement alternative when initially consolidating a CFE when the conditions below are met.

All financial assets and financial liabilities, other than those that are incidental to the CFE's operations and have carrying amounts that approximate fair value (for example, cash, broker receivables, or broker payables) are measured at fair value.

+

The changes in the fair values of those financial assets and financial liabilities are recognized in net income.

=

Eligible to elect measurement alternative.

If the CFE does not meet these conditions, the reporting entity accounts for the CFE's assets and liabilities at fair value in accordance with ASC 820.

If the measurement alternative is elected, the next step is to determine whether the fair value of the CFE's financial assets or financial liabilities is more observable. Based on that determination, the CFE would measure its assets and liabilities as follows:

FINANCIAL ASSETS ARE MORE OBSERVABLE	FINANCIAL LIABILITIES ARE MORE OBSERVABLE
▶ Measure financial assets at fair value ▶ Measure financial liabilities at: • The fair value of the financial assets **plus** • The carrying amounts of financial assets incidental to the CFE's operations (which approximate fair value) **plus** • The carrying amounts of nonfinancial assets held temporarily **minus** • The fair value of beneficial interests retained by the reporting entity (other than those that are compensation for services) **minus** • The reporting entity's carrying amounts of beneficial interests that are compensation for services	▶ Measure financial liabilities at fair value ▶ Measure financial assets at: • The fair value of the financial liabilities (other than beneficial interests retained by the entity) **plus** • The carrying values of financial liabilities that are incidental to the CFE's operations (which approximate their fair value) **plus** • The fair value of beneficial interests retained by the reporting entity (other than those that are compensation for services) **plus** • The reporting entity's carrying amounts of beneficial interests that are compensation for services **minus** • The carrying amounts of nonfinancial assets held temporarily
▶ The reporting entity recognizes any gain or loss that results from the initial application of this measurement alternative in earnings and attributes it to the reporting entity (that is, to the parent or controlling financial interest) in the consolidated income statement.	

A reporting entity measures beneficial interests that are compensation for services (for example, management or servicing fees) and any nonfinancial assets held temporarily by the CFE in accordance with other U.S. GAAP.

If a reporting entity does **not** elect the measurement alternative for a CFE, it measures the fair value of the financial assets and the fair value of the financial liabilities in accordance with ASC 820, and any initial difference is recognized in net income attributable to the reporting entity (that is, to the parent or controlling financial interest) in the consolidated income statement.

ASC 810-10-55-205AS through 55-205AT illustrates this guidance; also see ASC 810-10-35-6 through 35-9 for guidance on subsequent measurement of a CFE.

7.2.4 Initial Measurement of a VIE as Part of a Joint Venture Formation in Accordance With ASC 805-60

FASB REFERENCES

ASC 810-10-20: Joint Venture, ASC 810-10-30-5, and ASC 805-60

ASU 2023-05 provides guidance for the accounting by a reporting entity that meets the definition of a joint venture in U.S. GAAP at its formation date. At its formation date, the joint venture applies a new basis of accounting, in which it recognizes and initially measures its assets and liabilities at fair value (with exceptions consistent with the business combinations guidance).

ASU 2023-05 also amended ASC 810 and applies to the initial measurement of a VIE controlled by the joint venture reporting entity at its formation date. However, this amendment does not change the requirements in ASC 810 for evaluating whether a joint venture reporting entity controls a legal entity using the VIE model; it just changes the initial measurement guidance for the VIE at the reporting entity joint venture's formation date. See ASC 805-60 and BDO's Bulletin, New Accounting for Joint Venture Formations, for guidance.

7.3 SUBSEQUENT MEASUREMENT OF A VIE

The consolidation principles in ASC 810 apply to both VIEs and voting interest entities. The subsequent measurement of the assets, liabilities, and NCI generally are the same regardless of whether the subsidiary is a VIE or a voting interest entity, including retaining specialized or industry-specific accounting. However, ASC 810 includes specific guidance for eliminating intra-entity transactions between a VIE and its primary beneficiary (see Section 7.3.1).

7.3.1 Intercompany Eliminations for a VIE

FASB REFERENCES

ASC 810-10-35-3 and ASC 810-10-45-18

Intercompany transactions are eliminated in consolidation. Eliminations of transactions between the primary beneficiary and the VIE must be allocated to the primary beneficiary (not to the NCI) in the consolidated financial statements. This differs from the guidance for voting interest entities, in which the elimination of intercompany transactions **may** be allocated between the parent and the NCI.

Examples 7-2 and 7-3 illustrate the difference in attributing eliminating entries between the reporting entity and:

- A subsidiary that is a VIE in accordance with the VIE consolidation model.
- A subsidiary that is a voting interest entity using one acceptable method (other methods, including the VIE method, also are acceptable for eliminating intercompany transactions with a voting interest entity).

EXAMPLE 7-2: INTERCOMPANY ELIMINATION BETWEEN THE REPORTING ENTITY AND A VIE

FACTS

- A legal entity is a VIE and has two variable interest holders: the reporting entity and Investor A.
- The reporting entity holds 20% of the legal entity's equity and 100% of its debt and is its primary beneficiary.
- Investor A holds the remaining 80% of the legal entity's equity.
- During the year, the reporting entity recognized interest income of $3,000 from the legal entity, which recognized a corresponding amount of interest expense.

ANALYSIS AND CONCLUSION

	PARENT	VIE	ELIMINATIONS	CONSOLIDATED
Revenue	$ 20,000	$ 9,000	$ –	$ 29,000
Cost of revenue	15,000	7,000	–	22,000
Gross margin	5,000	2,000	–	7,000
Interest income	3,000	–	(3,000)	–
Interest expense	–	(3,000)	3,000	–
Net income (loss)	8,000	(1,000)	–	7,000
Net income (loss) attributable to NCI*				(800)
Net income attributable to the controlling interest				$ 7,800

* The attribution of the legal entity's net income (loss) to the NCI is calculated as follows: $1,000 * 80% = $800.

- The reporting entity (the primary beneficiary) consolidates the legal entity and presents the 80% of the legal entity's equity that it does not hold as NCI.
- The reporting entity attributes 80% of the legal entity's net income to NCI and 20% to the controlling interest. When eliminating interest income and interest expense, the reporting entity **must** attribute the eliminations entirely to the primary beneficiary.

EXAMPLE 7-3: INTERCOMPANY ELIMINATION BETWEEN THE REPORTING ENTITY AND A VOTING INTEREST ENTITY

FACTS

- Assume the same facts as in Example 7-2 except the legal entity is a voting interest entity and the reporting entity has control with less than a majority ownership interest (see Section 6.4.5) because it has the right to appoint the majority of the board members.

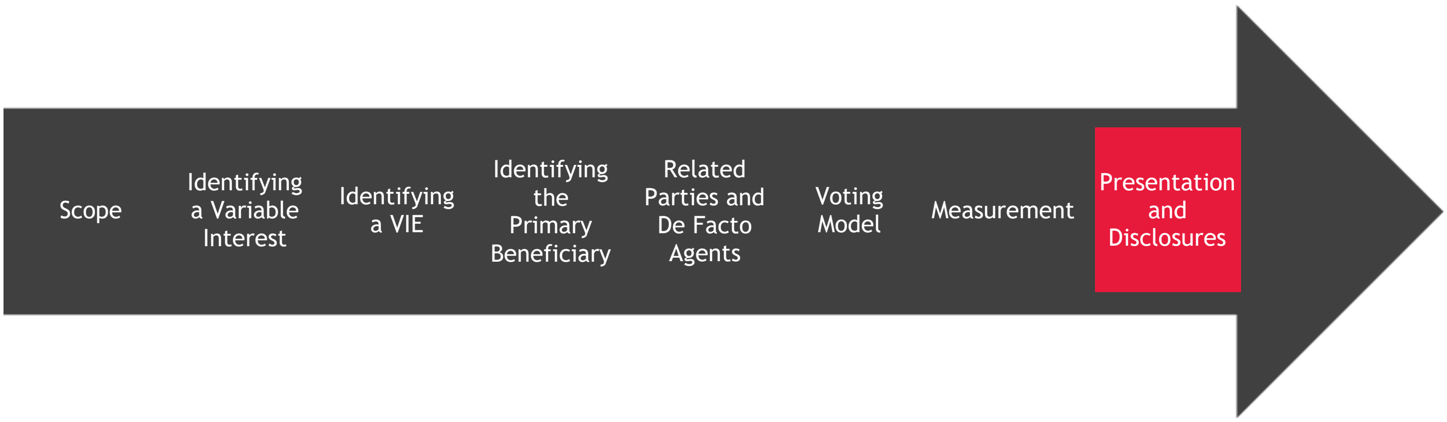
ANALYSIS AND CONCLUSION

	PARENT	SUBSIDIARY	ELIMINATIONS	CONSOLIDATED
Revenue	$ 20,000	$ 9,000	$ —	$ 29,000
Cost of revenue	15,000	7,000	—	22,000
Gross margin	5,000	2,000	—	7,000
Interest income	3,000	—	(3,000)	—
Interest expense	—	(3,000)	3,000	—
Net income (loss)	8,000	(1,000)	—	7,000
Net income (loss) attributable to NCI*				1,600
Net income attributable to the controlling interest				$ 5,400

* The attribution of the legal entity's net income (loss) to the NCI is calculated by adding back the $3,000 of eliminated interest expense to the legal entity's net loss of $1,000 = $2,000 * 80% = $1,600.

- The reporting entity consolidates the legal entity and presents the 80% of the legal entity's equity that it does not hold as NCI.
- The reporting entity attributes 80% of the legal entity's net income to NCI and 20% to the controlling interest (that is, to the reporting entity's shareholders). When eliminating interest income and interest expense between the reporting entity (the controlling interest) and the NCI, the reporting entity **elects** to allocate the eliminations proportionately between them based on the relative ownership interests of the legal entity, which is one acceptable method of allocation for a voting interest entity.

Chapter 8 — Presentation and Disclosures



8.1 OVERVIEW

ASC 810 contains general presentation and disclosure requirements that apply to both VIEs and voting interest entities. This chapter focuses only on incremental presentation and disclosure requirements for VIEs.

The primary beneficiary is required to separately present specific assets and liabilities of the VIE on its balance sheet (see Section 8.2) but does not have to separately present a consolidated VIE's income, expenses, or cash flows (although it is not prevented from doing so).

ASC 810 also requires specific disclosures for a VIE's primary beneficiary and all other variable interest holders in a VIE (see Section 8.3). The objectives of these disclosures are to help financial statement users understand:

- The significant judgments and assumptions made by a reporting entity in determining whether it:
  - Consolidates a VIE
  - Discloses information about its involvement in a VIE
- The nature of restrictions on a consolidated VIE's assets and the settlement of its liabilities, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks from a reporting entity's involvement with the VIE
- How a reporting entity's involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows

To meet these objectives, a reporting entity may need to supplement the required disclosures (see Section 8.3.1.1) depending on the facts and circumstances.

ASC 810 also requires disclosures when using a scope exception from the VIE model (see Section 8.3).

8.2 PRESENTATION

ASC 810 contains general presentation requirements that apply to both VIEs and voting interest entities. Section 8.2.1 focuses only on incremental presentation and disclosure requirements for VIEs.

8.2.1 Incremental Presentation Requirements for VIEs

FASB REFERENCES

ASC 810-10-45-25

The following table summarizes the incremental presentation requirements in ASC 810 for a consolidated VIE.

	PRESENTATION REQUIREMENTS
Balance Sheet	Present each of the following separately: ▶ Assets of a consolidated VIE that the reporting entity can use only to settle the VIE's obligations ▶ Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the primary beneficiary's general credit
Income Statement	No incremental presentation requirements for VIEs
Equity Statement	No incremental presentation requirements for VIEs
Cash Flow Statement	No incremental presentation requirements for VIEs

BDO INSIGHTS — PRESENTATION IN PRACTICE

When separate presentation of a VIE's assets or liabilities is required, reporting entities generally present either:

- The VIE's assets and liabilities with the reporting entity's other assets and liabilities and parenthetically disclose the amounts related to the VIE by line item.
- Line items for the VIE's assets and liabilities separately from the reporting entity's other assets and liabilities.

A reporting entity must separately present such assets and liabilities on a gross, not net, basis for each major asset or liabilities class on the balance sheet (for example, accounts receivable or accounts payable). Presenting only the VIE's net assets or total assets and total liabilities would be inconsistent with ASC 810.

BDO INSIGHTS — AGGREGATING ASSETS OR LIABILITIES FOR MULTIPLE VIES

When consolidating multiple VIEs, we believe the reporting entity can apply the aggregation principles for VIE disclosures (see Section 8.3.1) when separate presentation of a VIE's assets or liabilities is required.

8.2.1.2 Presentation Requirements for Collateralized Financing Entities

A CFE can issue beneficial interests in the form of debt or shares. A reporting entity that consolidates a CFE must present beneficial interests in a CFE issued in the form of debt as liabilities. The SEC staff said a reporting entity cannot present beneficial interests in a CFE that is not a business as equity.

SEC STAFF GUIDANCE

[Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB Developments]

Brian W. Fields, Professional Accounting Fellow, SEC Office of the Chief Accountant

> *… we've recently heard of efforts to structure certain sales of beneficial interests in a manner that some believe falls outside the scope of Codification Topic 860 on transfers of financial assets. Those efforts involved selling preferred interests in a subsidiary that holds only financial assets rather than selling senior interests in the financial assets themselves. The idea seems to be that by describing the beneficial interests sold as equity in a consolidated subsidiary it may be possible to classify the proceeds received as noncontrolling equity interests rather than collateralized debt in the financial statements of the parent sponsor...*
>
> *…While these structures contain only financial assets and do not have the breadth and scope of activities of a business, some believe that by describing the beneficial interests sold as legal form equity and not including an explicit maturity date they can classify securitization proceeds received as noncontrolling equity interests in the consolidated financial statements of the parent sponsor. We have reached a different view in these circumstances. Beneficial interests in such entities are essentially transfers of interests in financial asset cash flows dressed up in legal entity form, and we believe the proceeds received on such transfers should be presented as collateralized borrowings pursuant to transfer accounting requirements to the extent the underlying financial assets themselves do not qualify for derecognition…*
>
> *To say it again in another way, when a subsidiary is created simply to issue beneficial interests backed by financial assets rather than to engage in substantive business activities, we've concluded that sales of interests in the subsidiary should be viewed as transfers of interests in the financial assets themselves. The objective of an asset-backed financing is to provide the beneficial interest holders with rights to a portion of financial asset cash flows and the guiding literature is contained in Codification Topic 860 on transfers of financial assets. That literature requires a transfer to be reflected either as a sale or collateralized borrowing, depending on its specific characteristics-presentation as an equity interest in the reporting entity is not a possible outcome.”* [Footnotes omitted.]

8.3 DISCLOSURE REQUIREMENTS

ASC 810 contains general disclosure requirements that apply to both VIEs and voting interest entities. Section 8.3.1 focuses only on incremental presentation and disclosure requirements for VIEs:

- Section 8.3.1.1: Required Disclosures for Variable Interest Holders in a VIE
- Section 8.3.1.2: Required Disclosures for Money Market Funds
- Section 8.3.1.3: Required Disclosures for Entities Created Before 2003
- Section 8.3.1.4: Required Disclosures for Private Companies That Use the Accounting Alternative
- Section 8.3.1.5: Required Disclosures for Collateralized Financing Entities

8.3.1 VIE Disclosure Objectives and Requirements

FASB REFERENCES

ASC 810-10-50-2AA through 50-2AC and ASC 810-10-50-9 through 50-10

The objectives of the required VIE disclosures are to help financial statement users understand:

- The significant judgments and assumptions made by a reporting entity in determining whether it:
  - Consolidates a VIE
  - Discloses information about its involvement in a VIE
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks from a reporting entity's involvement with the VIE
- How a reporting entity's involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows

A reporting entity can aggregate VIE disclosures for similar entities if separate reporting would not provide more useful information to financial statement users. However, the reporting entity must explain the nature and extent of its involvement with VIEs and cannot aggregate disclosures for consolidated VIEs with disclosures for unconsolidated VIEs. When determining which disclosures to aggregate, quantitative and qualitative information is considered:

- The different risk and reward characteristics of each VIE
- The significance of each VIE to the reporting entity

A reporting entity must balance between too much aggregation and too much detail; either can obscure important information or provide information in a way that may not be useful. Therefore, when determining which disclosures to include:

Consider information relevant to users' understanding of the reporting entity's involvement with the VIE, including judgments made, risks involved, and impact to the financial statements.

Consider the level of detail necessary based on the VIE's significance and its risk and reward characteristics.

Disclose information about the reporting entity's involvement with VIEs in sufficient detail to meet the disclosure objectives.

To meet these objectives, a reporting entity may need to supplement the required disclosures (see Section 8.3.1.1) depending on the facts and circumstances. A reporting entity is not required to provide all disclosures in a single location; it may disclose the information in more than one note to the financial statements, if it **both**:

- Presents all information necessary to meet the disclosure objectives
- Includes cross-references to the other notes to the financial statements that disclose the required information

8.3.1.1 Required Disclosures for Variable Interest Holders in a VIE

FASB REFERENCES

ASC 810-10-50-3 through 50-5B

The following table summarizes the disclosure requirements in ASC 810 for all entities involved with a VIE. All reporting entities are in Group 1 and must disclose that required information. A VIE's primary beneficiary must provide the Group 2 required disclosures, and variable interest holders other than primary beneficiaries must provide the Group 3 required disclosures.

	DISCLOSURE REQUIREMENT
Group 1: All variable interest holders (including the primary beneficiary)	▶ Methodology for determining whether the reporting entity is the VIE's primary beneficiary, including significant judgments and assumptions ▶ Facts and circumstances that changed a reporting entity's conclusion about whether it is a VIE's primary beneficiary, including the effects on its financial statements ▶ Whether the reporting entity has explicitly or implicitly provided financial or other support to the VIE in the periods presented when the reporting entity was not contractually obligated to do so, or whether the reporting entity intends to provide such support, including: • The type and amount of support • The primary reasons for providing the support ▶ Quantitative and qualitative information about a reporting entity's involvement with a VIE (considering both explicit and implicit variable interests), including the VIE's nature, purpose, size, activities, and financing
Group 2: Primary beneficiary	▶ The carrying amounts and classification of the VIE's assets and liabilities ▶ Qualitative information about the relationships between the VIE's assets and liabilities (for example, the nature of restrictions on the VIE's assets) ▶ Lack of recourse if the VIE's creditors (or beneficial interest holders) have no recourse to the primary beneficiary's general credit ▶ Terms of arrangements (considering explicit and implicit variable interests) that could require a reporting entity to provide financial support to the VIE (for example, liquidity arrangements or obligations to purchase assets), including events or circumstances that could expose the reporting entity to a loss ▶ If the VIE is a business, disclosures required by other U.S. GAAP (for example, ASC 805) * ▶ If the VIE is not a business, the gain or loss recognized upon initial consolidation of the VIE (see Section 7.2.2)

	DISCLOSURE REQUIREMENT
Group 3: Variable interest holders other than the primary beneficiary	▶ The carrying amounts and classification of assets and liabilities related to the variable interest ▶ The reporting entity's maximum exposure to loss from its involvement with the VIE, including how the exposure is determined and the significant sources of exposure to the VIE (or a statement that it cannot quantify the maximum exposure to loss) ▶ A tabular comparison of such assets and liabilities and the reporting entity's maximum exposure to loss, including qualitative and quantitative information about differences between the amounts to enable users to understand those differences, such as explicit or implicit arrangements that could require a reporting entity to provide financial support to the VIE, including events or circumstances that could expose the reporting entity to a loss ▶ Information about liquidity arrangements, guarantees, or other commitments by third parties that may affect the fair value or risk of the reporting entity's variable interest is encouraged ▶ If applicable, 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 (see Section 4.2.4)

Generally, Group 1 and Group 2 disclosures are not required for a VIE's primary beneficiary if **all** the following criteria are met:

- The VIE issues voting equity.
- The primary beneficiary holds a majority voting equity interest in the VIE.
- The VIE meets the definition of a business in ASC 805 (including by using the screen test discussed in ASC 805-10-55-5A through 55-5C).
- The reporting entity can use the VIE's assets other than to settle the VIE's obligations.

However, the disclosure marked with (*) in Group 2 are not part of this exception and therefore are always required.

BDO INSIGHTS — ESTIMATING THE MAXIMUM EXPOSURE TO LOSS

We believe the maximum exposure to loss is the amount the reporting entity would recognize in its income statement from its involvement with the VIE, including:

- The amount invested in or advanced to the VIE
- Any legal or contractual obligation or commitment (whether recognized or unrecognized) to provide future financing or advances

This disclosure is required regardless of whether it is probable that an actual loss will occur.

CONSIDER VIE DISCLOSURE REQUIREMENTS DURING NEGOTIATIONS

Preparing disclosures about a VIE may be difficult if the required information is not readily available. For example, a VIE might not prepare financial statements promptly or in accordance with U.S. GAAP, or the reporting entity might not have the right to receive the necessary information. During negotiations, a reporting entity should consider what information it will need to comply with the VIE disclosure requirements for its financial reporting.

8.3.1.2 Required Disclosures for Money Market Funds

FASB REFERENCES

ASC 810-10-15-12(f)(2)

A reporting entity does not consolidate a registered fund that is required to comply with Rule 2a-7 of the 1940 Act (a money market fund) or a fund that complies with or operates in accordance with similar requirements based on its purpose and design (see Section 1.3.4). When this scope exception applies, a reporting entity must disclose both:

- Explicit arrangements to provide financial support to the legal entity
- Past financial support provided to the legal entity during the periods presented in the income statement

Financial support includes:

- Capital contributions
- Standby letters of credit
- Guarantees of principal and interest on the legal entity's debt investments
- Agreements to buy financial assets for more than fair value
- Waivers of fees, including management fees

8.3.1.3 Required Disclosures for Entities Created Before 2003

FASB REFERENCES

ASC 810-10-50-6

If, after an exhaustive effort, a reporting entity is unable to get the information to apply the VIE model to a legal entity created before 2003 (see Section 1.4.3), it must disclose all of the following:

- The number of legal entities for which the reporting entity did not apply the VIE model and the reason the necessary information is unavailable
- The nature, purpose, size (if available), and activities of the legal entities
- The nature of the reporting entity's involvement with the legal entities
- The reporting entity's maximum exposure to loss because of its involvement with the legal entities
- The income, expense, purchases, sales (or other measures of activity) between the reporting entity and the legal entities for all periods presented

8.3.1.4 Required Disclosures for Private Companies That Use the Accounting Alternative

FASB REFERENCES

ASC 810-10-50-2AG through 50-2AI

If a reporting entity elects the private company accounting alternative (see Section 1.4.5), it discloses the following:

- The nature and risks from its involvement with the legal entity under common control
- The effect on its financial position, financial performance, and cash flows from its involvement
- The carrying amounts and classification of assets and liabilities on its balance sheet from its involvement
- Its maximum exposure to loss from its involvement (or a statement that it cannot quantify the maximum exposure)
- If its maximum exposure to loss exceeds the carrying amounts of the assets and liabilities on its balance sheet from its involvement, qualitative and quantitative information about the excess exposure, including:
  - The terms of explicit and implicit arrangements that could require the reporting entity to provide financial support to the legal entity under common control (for example, an implicit guarantee to fund losses)
  - The events or circumstances that could expose the reporting entity to a loss

A reporting entity must consider the facts and circumstances to determine its exposure through implicit arrangements, including implicit guarantees (see Section 2.6), such as when the reporting entity:

- Has an economic incentive to function as a guarantor or make funds available to the legal entity under common control in the future
- Functioned as a guarantor for or made funds available to the legal entity under common control in the past

A reporting entity also must comply with other U.S. GAAP disclosure requirements (for example those in ASC 460, *Guarantees*, ASC 850, and ASC 842) with respect to its involvement with the legal entity. A reporting entity can combine disclosures in a single note or cross reference the information.

BDO INSIGHTS — ESTIMATING THE MAXIMUM EXPOSURE TO LOSS

We believe the maximum exposure to loss is the amount the reporting entity would recognize in its income statement from its involvement with the VIE, including the amount invested in or advanced to the VIE and any legal or contractual obligation or commitment (recognized or unrecognized) to provide future financing or advances. This disclosure is required regardless of whether it is probable that an actual loss will occur.

8.3.1.5 Required Disclosures for Collateralized Financing Entities

FASB REFERENCES

ASC 810-10-50-20 through 50-22

A reporting entity that consolidates a CFE and uses the measurement alternative (see Section 7.2.3) must comply with disclosure requirements in ASC 820 and ASC 825, *Financial Instruments*, for the consolidated CFE's financial assets and financial liabilities. For the less observable of the fair value of the financial assets and financial liabilities, a reporting entity also must disclose that the amount was measured based on the more observable fair value of the financial assets and financial liabilities. However, these disclosures do not apply to financial assets and financial liabilities that are incidental to the CFE's operations and have carrying amounts approximating fair value.

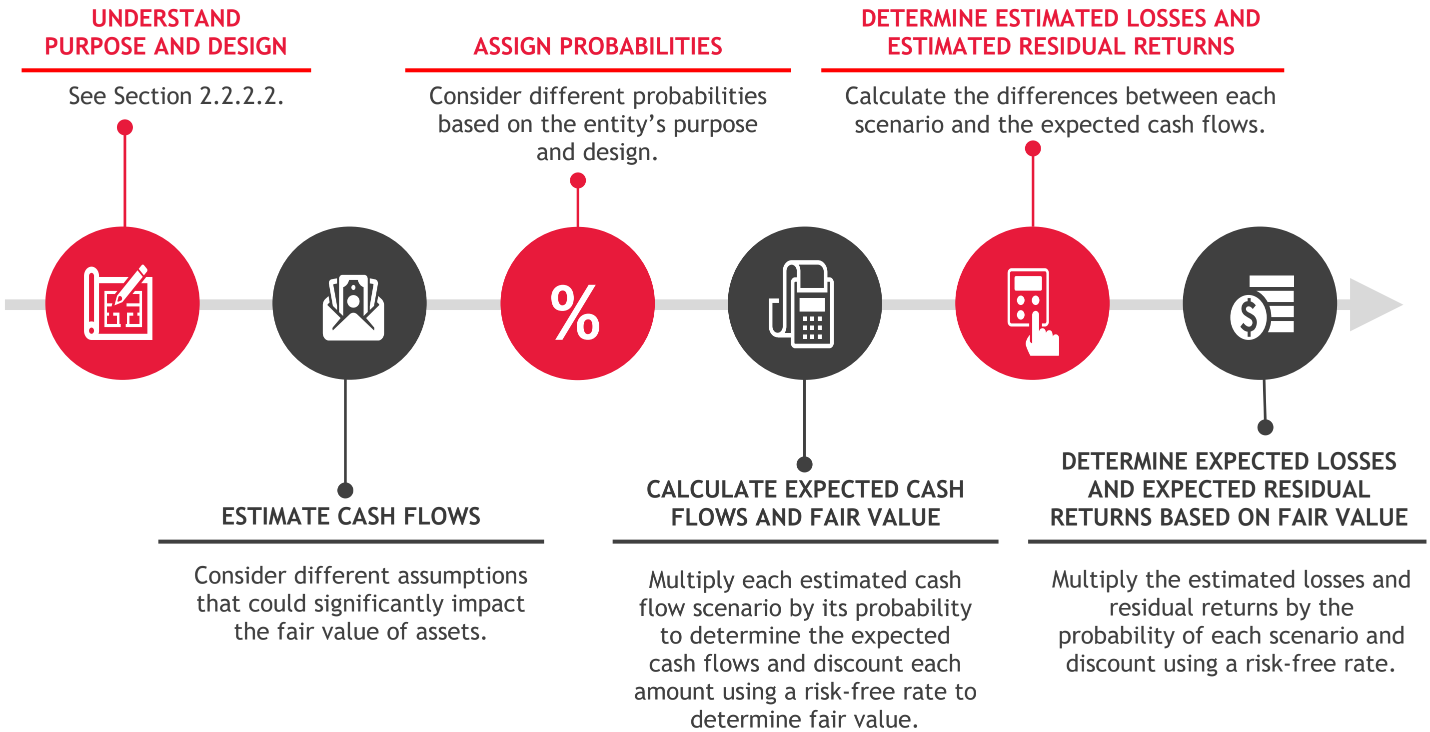
Appendix A — Quantitatively Identifying Variability

FASB REFERENCES

ASC 810-10-55-42 through 55-54

A reporting entity can qualitatively identify variable interests and assess whether a legal entity has sufficient equity at risk without quantifying the legal entity's expected losses (see Section 2.2.2.1). In practice, it is rarely necessary to quantitatively determine expected losses, expected residual returns, and expected variability. Such a determination can be complex when a legal entity has multiple assets with variability in timing and cash flows and requires the application of professional judgment based on the facts and circumstances.

In the rare cases when a quantitative approach is required, a reporting entity may use the approach shown below, which is consistent with ASC 810-10-55-42 through 55-49 (other approaches may also be acceptable).



Example A-1 illustrates the quantitative determination of expected losses, expected residual returns, and expected variability for a portfolio of assets that mature on a single date using the steps in the graphic above. A second example (for a single-asset lessor legal entity) in ASC 810-10-55-50 through 55-53 illustrates another approach to quantitatively measuring variability for a pool of assets that mature on various dates.

EXAMPLE A-1 (ADAPTED FROM ASC 810-10-55-42 THROUGH 55-49): ESTIMATING EXPECTED LOSSES, EXPECTED RESIDUAL RETURNS, AND EXPECTED VARIABILITY

FACTS

- A legal entity's only assets are a portfolio of investments that have total contractual cash flows of $1 million.
- The cash flows from the asset portfolio are expected to occur in one year (or never), as shown below. The discount rate (the interest rate on risk-free investments) is 5%.
- No other factors affect the assets' fair value. Therefore, the present value of the expected cash flows is equal to the assets' fair value.

CONCLUSION

The expected cash flows are $795,000, and the assets' fair value is $757,143. The expected losses are $26,667, and the expected residual returns are $26,667. Therefore, the expected variability is $53,334 (the combined absolute values).

ANALYSIS

ESTIMATED CASH FLOWS (A)	PROBABILITY (B)	EXPECTED CASH FLOWS (C) = (A*B)	FAIR VALUE (C DISCOUNTED AT 5%)
$ 650,000	5%	$ 32,500	$ 30,952
700,000	10	70,000	66,667
750,000	25	187,500	178,571
800,000	25	200,000	190,477
850,000	20	170,000	161,905
900,000	15	135,000	128,571
Total	100%	$ 795,000 (D)	$ 757,143

Scenarios with estimated cash flows less than the expected cash flows of $795,000 result in expected losses; scenarios with estimated cash flows greater than the expected cash flows of $795,000 result in expected residual returns.

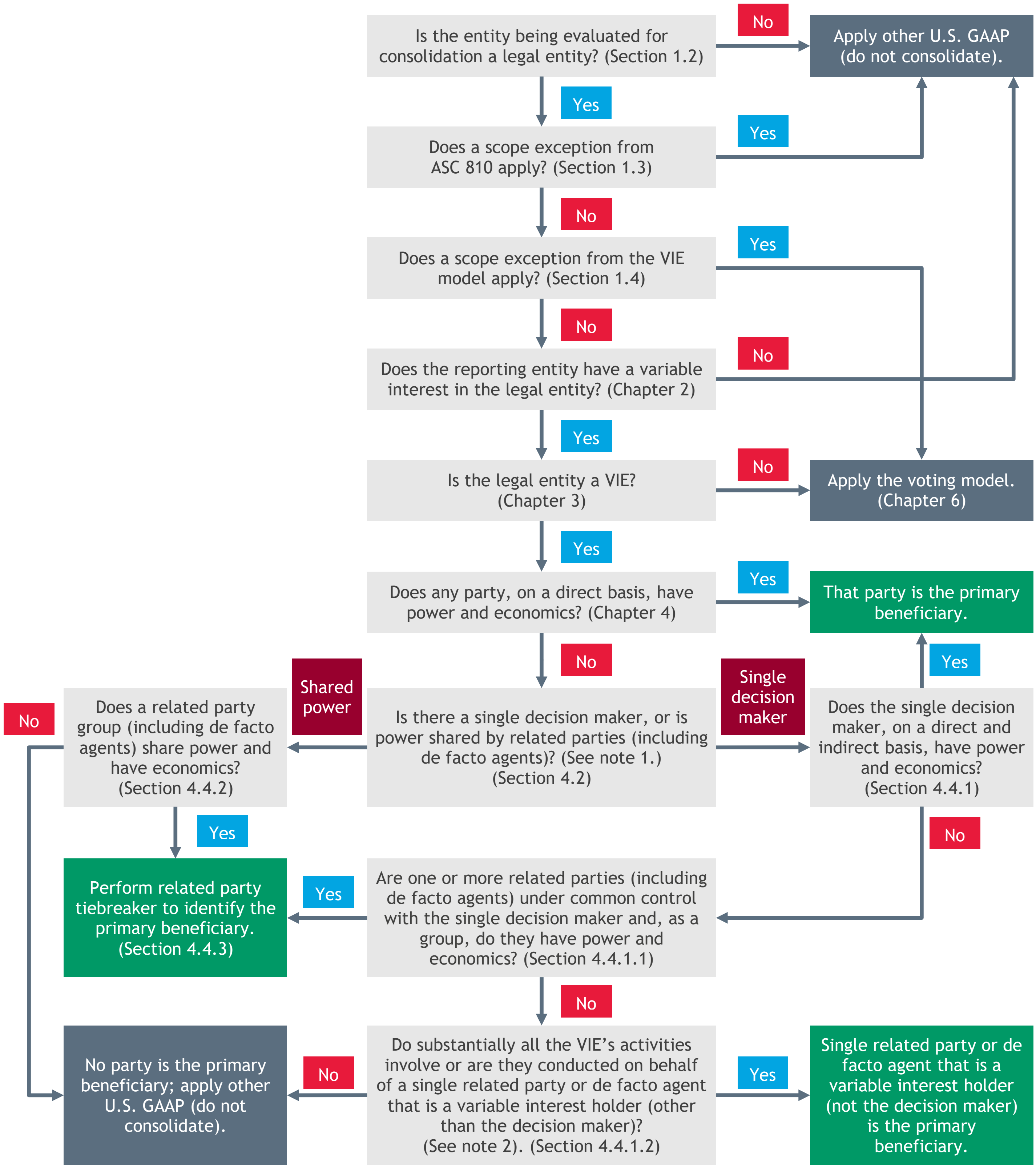
ESTIMATED CASH FLOWS (A)	EXPECTED CASH FLOWS (D)	ESTIMATED LOSSES) RESIDUAL RETURNS (E = A-D)	PROBABILITY (B)	EXPECTED (LOSSES) RESIDUAL RETURNS BASED ON CASH FLOWS (F) = (E*B)	EXPECTED (LOSSES) RESIDUAL RETURNS BASED ON FAIR VALUE (F DISCOUNTED AT 5%)
$ 650,000	$ 795,000	$ (145,000)	5%	$ (7,250)	$ (6,905)
700,000	795,000	(95,000)	10	(9,500)	(9,048)
750,000	795,000	(45,000)	25	(11,250)	(10,714)
			40%	$ (28,000)	$ (26,667)
800,000	795,000	5,000	25%	$ 1,250	$ 1,191
850,000	795,000	55,000	20	11,000	10,476
900,000	795,000	105,000	15	15,750	15,000
			60%	$ 28,000	$ 26,667
		Total	100%	$ –	$ –

The absolute values of the expected losses and expected residual returns are equal. Despite positive expected cash flows and fair value of the assets, the legal entity has expected losses.

Appendix B — Flowcharts

The following flowcharts in this Blueprint may be useful in applying the guidance in ASC 810.

DESCRIPTION	SECTION
The VIE model in a nutshell	Overview and below
Business scope exception	Section 1.4.4
Private company accounting alternative scope exception	Section 1.4.5
Determining whether a purchase or supply arrangement is a variable interest	Section 2.3.5
Determining whether a lease is a variable interest	Section 2.3.6
Evaluating the sufficiency of equity at risk	Section 3.2
Determining whether the holders of equity at risk collectively lack power ▶ Determining whether the holders of equity at risk collectively lack power for a corporation (and similar entities) ▶ Determining whether the holders of equity at risk collectively lack power for a limited partnership (and similar entities)	Section 3.3 ▶ Section 3.3.2 ▶ Section 3.3.3
Identifying the primary beneficiary	Sections 4.1 and 4.4
Four-step process for identifying the party with power	Section 4.2
Evaluating the effect of substantive kick-out rights and participating rights when identifying the primary beneficiary and determining how decisions are made	Section 4.2.2
The voting model	Section 6.1

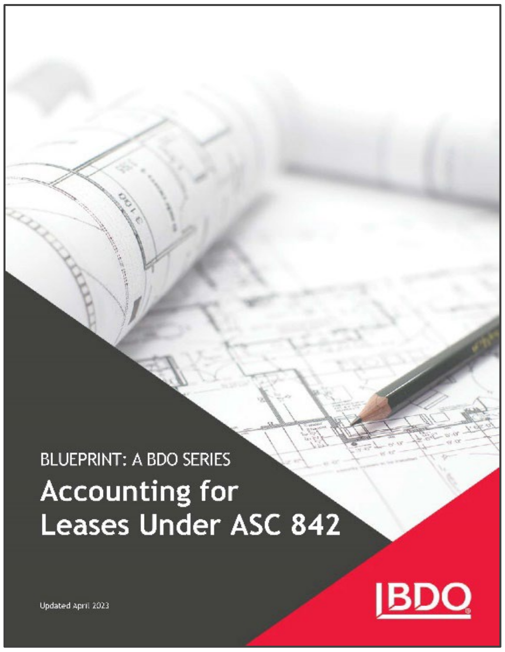


Is the entity being evaluated for consolidation a legal entity? (Section 1.2)
No
Apply other U.S. GAAP (do not consolidate).
Yes
Does a scope exception from ASC 810 apply? (Section 1.3)
Yes
No
Does a scope exception from the VIE model apply? (Section 1.4)
Yes
No
Does the reporting entity have a variable interest in the legal entity? (Chapter 2)
No
Yes
Is the legal entity a VIE? (Chapter 3)
No
Apply the voting model. (Chapter 6)
Yes
Does any party, on a direct basis, have power and economics? (Chapter 4)
Yes
That party is the primary beneficiary.
No
Is there a single decision maker, or is power shared by related parties (including de facto agents)? (See note 1.) (Section 4.2)
Shared power
Single decision maker
Does a related party group (including de facto agents) share power and have economics? (Section 4.4.2)
No
Yes
Does the single decision maker, on a direct and indirect basis, have power and economics? (Section 4.4.1)
Yes
No
Perform related party tiebreaker to identify the primary beneficiary. (Section 4.4.3)
Yes
Are one or more related parties (including de facto agents) under common control with the single decision maker and, as a group, do they have power and economics? (Section 4.4.1.1)
No
Do substantially all the VIE's activities involve or are they conducted on behalf of a single related party or de facto agent that is a variable interest holder (other than the decision maker)? (See note 2). (Section 4.4.1.2)
No
No party is the primary beneficiary; apply other U.S. GAAP (do not consolidate).
Yes
Single related party or de facto agent that is a variable interest holder (not the decision maker) is the primary beneficiary.

- **Note 1:** See Section 4.2.3 for guidance when there appear to be multiple decision makers. One of these parties generally is identified as the single decision maker. See Section 4.2.4 for guidance when parties that are not related parties or de facto agents share power.
- **Note 2:** This step applies only if the reporting entity and its related party group (including de facto agents) have power and economics (but no party individually has power and economics) and are not under common control.

Appendix C — BDO Blueprints

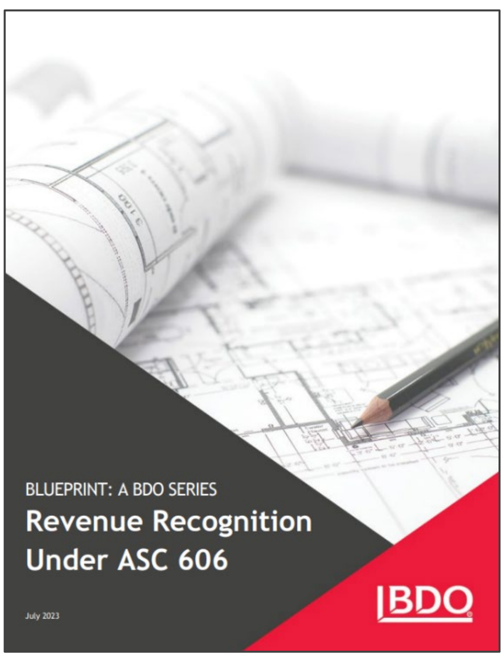
Other publications in BDO's Blueprint series are available on the BDO Center for Accounting Standards and Reporting Matters.



Accounting for Leases Under ASC 842

This Blueprint guides professionals through the application of ASC 842.

The Professional Practice Group updated this Blueprint in April 2023 for FASB amendments to ASC 842 and BDO Insights.



Revenue Recognition Under ASC 606

This Blueprint guides professionals through the application of ASC 606.

The Professional Practice Group issued this Blueprint in July 2023.

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